GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Iowa, Minnesota, Wisconsin, Georgia, Texas, Oklahoma, and Kansas!

BRANCH CLOSING POLICIES

We have recently been assisting a community bank client in closing one of its branches. If you are not familiar, the regulatory agencies have specific guidance on a branch closing process. Most bankers are familiar with the fact that a branch closure must be accompanied by certain notices to the regulators and notices to bank customers. What many bankers may not know is that when the regulators receive notice of an intended branch closure, one of the first things they are going to do is look at whether the branch closure complies with the bank's branch closure policy.

Our experience is that some banks do not realize there is a requirement to maintain a branch closure policy. If you do not have such a policy, we recommend you put one in place. As the name implies, a branch closure policy is a written policy that defines the terms, conditions, considerations, and circumstances under which a bank may choose to close a branch. If a bank does not have a branch closure policy and looks to close a branch, one of the first things the regulators are going to do is require the bank to adopt a branch closure policy. If you are thinking about that, we recommend you head them off at the pass and go ahead and put one in place.

As an aside, our favorite regulatory criticism was of a unit bank (a single location) being criticized for not having a branch closure policy when they had no branches.

M&A ENVIRONMENT

As we have noted in multiple *Musings*, the merger and acquisition environment is picking up. We believe as the economy continues to stabilize (along with interest rates) and buyers and sellers continue to visit (as they have over the past several years), that we will continue to see a growth in community bank acquisition transactions.

As most *Musings* readers know, we are staunchly in favor of independent community banks. We also do a lot of mergers and acquisitions for community banks on both the buy and the sell side because we realize there ultimately comes a time when a community bank may feel its best option is to sell the bank. One of the perpetual issues in community bank M&A in particular is the perception difference between the buyer's idea of an appropriate price for the bank and the seller's idea. This is even more acute when the seller bank ownership and/or its board of directors is older and remembers the 2.5 to 3 times book value sale days prior to the Great Recession. This disconnect between the seller's expectations and the buyer's ability to pay is a perpetual one that simply needs to be talked through, education provided, and ultimately negotiated. We have seen multiple situations where unrealistic expectations on the part of the seller has killed a deal, but for the most part, the sellers will eventually come around when they realize, in fact, their expectations are unrealistic in the market, and the buyers simply cannot justify paying the price they expect.

REGULATORY ENFORCEMENT ACTIONS

We couldn't let this edition of *Musings* go by without a regulatory comment. As we have indicated in prior *Musings*, we believe the regulatory environment is getting more and more difficult, particularly under the current Administration. The failure of the three large banks in 2023 simply accentuated the friendly federal regulators' intent on not again being caught unprepared, and the enforcement actions, both formal and informal, are proceeding at a rapid pace.

One issue with respect to an enforcement action, whether it is formal or informal, is how you get out of it once your Board and community bank voluntarily agree to it. The short answer is 1) you comply with what the regulators have asked, 2) you do what you said you would do, even if the regulators haven't asked, and 3) you ask the regulators to review the bank closely at their next examination or visitation and terminate the enforcement action. That's right, you ask the regulators. In other words, make your case and ask the regulators. If they turn you down at the next visitation or examination, you really have not lost anything. In fact, you have likely identified one of the remaining hot buttons there may be from a regulatory standpoint.

For most community banks, the goal, for a variety of reasons, is to get out from under that enforcement action as quickly as possible. Often, it takes an examination or two to clear it, but not always.

REGULATORY NONSENSE

Every now and then, we find ourselves in a situation where we simply do not see eye-to-eye with the friendly federal regulators. Our latest situation where this has occurred relates to a regulatory allegation that one of our clients engaged in an abusive act or practice related to its overdraft program. In this situation, the community bank went through an examination and was cited for a violation of the Federal Trade Commission Act. In order for an act or practice to be considered abusive under the Federal Trade Commission Act, three very specific legal requirements must be met.

The documentation the bank received from the regulators in which they were cited for the violation included very cursory and summary statements as to how the bank's actions satisfied the three legal criteria to be considered an abusive act or practice. On behalf of the bank, we submitted a very detailed legal analysis back to the regulators, fully explaining why the bank's practices failed to meet the legal requirements to establish a violation of the Federal Trade Commission Act. Six weeks or so after submitting our letter, we received the federal regulator's response.

To put it politely, the regulator's response was a bunch of nonsense. They provided about five pages that, in our view, completely failed to address any of the issues raised in our response letter. We told our client that our view is that the regulators really just expanded upon the previous summary statements and regulatory nonsense they provided in the examination report.

This is frustrating for a couple reasons. First, it does not give us much hope that the friendly federal regulators are carefully and thoughtfully considering the issues related to their newfound distaste of overdraft programs. It seems to us they have just decided they do not like overdraft programs and are going to do whatever they want to do, legal precedent be darned, to, in their view, reign them in. Second, it puts this community bank in a very difficult situation. It leaves the bank wondering exactly what it should do in terms of further fighting the allegation. We are working with our client through what we all believe to be a very frustrating set of circumstances.

PROFITABILITY

At every planning session we facilitate, we ask the Board to identify the bank's overall business strategy. For some, it is a focus on profitability only. For others, it is a focus on balance sheet growth with modest profitability. For most, it is a focus on profitability with some type of modest (however you define that, usually 3% to 6%) balance sheet growth.

We have recently been in several community banks where the focus is on no balance sheet growth. Keep in mind, if your community bank grows its balance sheet from $500 million to $600 million and the Board wants to maintain a 10% capital ratio, that requires $10 million in capital to either be injected or retained (typically through earnings) in the bank to support the growth. For some of the banks we have been with recently, their focus is back to, frankly, what it was coming out of the last recession - a reallocation of assets strategy. This is simply a reallocation of assets from securities and cash into loans, not a growth of the balance sheet which requires capital. For a number of years, while the unrealized loss in the bond portfolio was significant for most banks, there was not much of a possibility to engage in a reallocation of assets strategy. The only available strategy was to grow the balance sheet enough to fund the growth in the loan portfolio. Now that many of those unrealized bond losses are rolling off as the bonds mature, we are again seeing banks move to a reallocation of assets strategy instead of a balance sheet growth strategy as a way to continue to grow profitability. We generally take the position that it is always appropriate to grow the balance sheet to the extent the bank needs to fund the loan portfolio. We are, however, back to a situation where that growth is not as necessary as it was over the last couple of years because of the reduced unrealized loss in the bond portfolio. We view that as a positive.

LOAN PRODUCTION OFFICES

As banks continue to focus on profitability as noted above, the major source of profitability for virtually every community bank is continued growth in quality loans, conservative underwriting, and a safe and sound culture. Many of the community banks we have been with lately in planning sessions have indicated they are basically tapped out in their existing markets and need to expand beyond their markets. There are generally a couple of ways to do that. One is to hire the franchise player in the new market, put them in a loan production office (LPO), and eventually establish a branch in that market. The other way is simply to establish a loan production office. This may or may not involve hiring a franchise player in that market. It may simply involve utilizing personal in your own bank that may have relationships in other markets that they could mine. We have found that to be extraordinarily effective in multiple situations. Give it some consideration if it makes sense for your bank. The biggest objection we have heard to establishing LPOs (which can basically be a loan officer in his or her car with a laptop) is that it does not show commitment to the community and does not provide convenience for potential customers who may have significant deposit needs. Nevertheless, on balance, many banks decide that the establishment of a loan production office is certainly an appropriate strategy to pursue.

ORGANIZATIONAL STRUCTURE

As most *Musings* readers know, we harp regularly on making sure your bank is in the appropriate organizational structure. Our sister publication, *The Board Chair Forum Newsletter*, recently again pounded the table about making sure your bank is in a bank holding company structure. Most of the banks in the country (approximately 80%) are, but we still find a few that are not and need some further understanding of the benefits of the holding company structure. There are a multitude of these benefits which we would be happy to share. Just shoot us an email, and we will provide some information to you.

First among the benefits is the ability of the holding company, particularly for a bank under $3 billion, to generate capital through debt leverage (i.e., borrowing money) and injecting the cash into the bank. If your bank is in need of capital, the first place to look is holding company debt, not your existing shareholders, in most cases. Holding company debt allows the shareholders to maintain their current percentage of ownership without having to outlay any cash or otherwise change their financial position as the bank continues to support its growth and other activities through debt leverage. A holding company also provides other benefits, including that of organizational structure, providing liquidity opportunity for the bank's shareholders, and enhancing shareholder value.

Recently we have run into banks that either do not have holding companies or banks that have multiple subsidiaries under their holding company. We certainly understand that typically multiple subsidiaries result from a point in time when, for whatever reason, it was likely not politically feasible to merge the subsidiary banks together. We encourage boards, however, to keep a continuous eye on situations where you have multiple bank subsidiaries to make sure it still makes sense. There are typically significant economies of scale with respect to putting the banks together, as well as simple expense reductions. Just because your holding company has had multi-bank subsidiaries for a long time, do not necessarily assume that that is the way it should continue.

OREO OR SPECULATION?

We recently had a community bank client contact us with a question about the permissibility of their intended activities as it relates to a piece of OREO property. This particular bank has recently taken back a piece of property as OREO that is in disrepair. The condition of the property is bad, and the client believes that it is not going to be easy to sell in its current condition. The bank anticipates some level of meaningful loss without fairly substantial improvements to the property.

The bank asked us what sort of latitude they have in spending money to improve the property to prepare it for sale. Our answer is "it depends." The bank is certainly allowed to spend money to maintain the property and prepare it for sale. The bank is not allowed to speculatively invest in real estate. Where one ends and the other begins is often difficult to immediately decipher.

In our experience, the regulators typically do not take too much offense at banks that spend relatively small amounts of money to improve OREO to make it marketable and allow the foreclosed capital to be converted back to cash. On the other hand, we have seen a number of instances where the regulators have taken strong exception to banks they believe are "speculating in real estate." For banks, it can sometimes be difficult to decipher between the two. The obvious situation that should always look to be avoided is the set of circumstances where the bank believes it is incurring expenses to prepare a property for sale while the regulators believe it is speculatively investing in real estate.

DIVIDENDS ARE SACRED

Every now and then, we get to see familiar situations from a different point of view. Most often, when we talk about dividends, we do so in the context of strategic planning or other discussions with a bank board. These discussions generally involve evaluating capital levels, alternative capital allocations, growth, and similar strategies. They also often involve discussion on how the shareholders might react to a change in the dividend, either positively or negatively.

Recently, we had this same discussion from a little bit different point of view. Over the past couple of weeks, we had a discussion with a community bank shareholder that is not involved in the bank as a board member or on a day-to-day basis. This individual has a pretty substantial investment in a bank holding company and is properly characterized as a passive investor.

Our client recently received word from the bank President that the bank was expecting to cut dividends. This is because profitability has slightly decreased and growth has maintained a steady pace. The shareholder was not too terribly pleased to hear the news. Of course, no one likes to see a reduction in after-tax cash flow. Also, it gives some concern as to the safety and soundness of the bank.

This situation reminded us that many community bank shareholders see dividends as sacred. Our experience is that most bank boards do not cut dividends except as a last true resort. Most boards and shareholders view dividends as sacred. We have been through many strategic planning sessions where boards have totally bristled at the idea of cutting dividends for any reason other than an absolute necessity.

CONCLUSION

It's hard to believe we are at the end of the second quarter of 2024 already. The next *Musings* will be published after the 4th of July holiday. We hope all of you have a great and relaxing Independence Day. We look forward to visiting with many of you over the next two weeks.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations

- July 14-26, 2024 – Graduate School of Banking at the University of Colorado. "Enhancing Shareholder Value" (July 15-19) (Greyson Tuck, Instructor) Registration: GSB Colorado
- July 28 – August 9, 2024 - Graduate School of Banking at the University of Wisconsin-Madison. "Enhancing Shareholder Value With or Without a Sale" (July 29-30) (Philip Smith, Instructor) Registration: GSB - Wisconsin
- August 5-7, 2024 – Community Bankers Association of Ohio, 50th Annual Convention at The Hilton Columbus Downtown. "The Next Chapter for America's Banks" (August 6) (Philip Smith, Presenter) Registration: CBAO 50th Annual Convention
- August 11-14, 2024 – Independent Community Bankers of America Credit Analyst Institute at Embassy Suites Grapevine, Grapevine, Texas. "Legal Issues and Regulatory and Compliance Matters" (August 13) (Doc Bodine, Instructor) Registration: Credit Analyst Institute

- August 18-23, 2024 – Independent Community Bankers of America Commercial Lending Institute at Embassy Suites Minneapolis Airport, Bloomington, Minnesota. "Legal Issues" (August 22) (Doc Bodine, Instructor) Registration: Commercial Lending Institute
- August 22-25, 2024 - Southwestern Graduate School of Banking 158th Assembly for Bank Directors, at The Coeur d'Alene Golf & Spa Resort, Coeur d'Alene, Idaho. "Critical Information for Bank Board Members" (August 23) (Greyson E. Tuck, Presenter) / "The Idiosyncrasies of Directors' Liability Insurance" (August 24) (Doc Bodine, Presenter) Registration: SWGSB Assembly for Bank Directors
- September 10, 2024 - Independent Community Bankers of America (Webinar). "Community Bank Director Guide to Compliance Issues" (Doc Bodine, Presenter) Registration: Community Bank Director Guide to Compliance Issues
- September 11-13 – Tennessee Bankers Association Community Banking Conference (Sept. 11-12) and Bank Directors Retreat (Sept. 12-13) at Hilton Franklin Cool Springs. "Succession Planning for Directors of Community Banks" (Sept. 12); "Strategies to Grow Your Bank and How to Maximize Your Bank's Value" (Sept. 13) (Greyson Tuck, Presenter) Registration: TBA Community Banking Conference and Bank Director Retreat
- September 18-20, 2024 – Louisiana Bankers Association Executive Management Conference at The Grand Hotel Golf Resort & Spa, Point Clear, Alabama. "A Look to the Future: The Financial Services Industry in 2044" (Sept. 19) (Greyson Tuck, Presenter) Registration: Executive Management Conference

