GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Illinois, West Virginia, Ohio, Iowa, Wisconsin, Minnesota, Nebraska, Georgia, Alabama, Mississippi, Florida, and Indiana!

FINALLY, YES FINALLY

Over the years we don't believe we have ever heard anything out of the Consumer Financial Protection Bureau, particularly its Director, Rohit Chopra, that we have agreed with, until now. Finally, the CFPB Director said something that community banks can agree with. What he said was the same thing we commented on in the last *Musings*, and that is, "It is fundamentally unfair" that depositors at Silicon Valley Bank and Signature Bank got paid 100% of their deposits, insured or not, and the uninsured depositors at the small Oklahoma bank, The First National Bank of Lindsay, failure, did not.

Although years have passed, we find it hard to believe that the CFPB Director finally said something we agree with, but he finally did.

FAST GROWTH

Can your community bank grow too fast? That's a question that is often asked by community bank boards of directors that are pushing "growth, growth, growth." First, we need to understand what growth we are talking about. Most often, even if some of the outside directors do not fully understand it, it is balance sheet growth. Growing the total asset size of the bank. This means adding deposits or Federal Home Loan Bank advances with the idea that those deposits or advances will be used to fund loans, and growth and profitability will result. So the question is, can your community bank's balance sheet grow too fast? The answer is, "not if you keep your eye on the ball."

By the ball, we mean "is capital still adequate and is the growth resulting in quality, sustainable earnings." The banks that are growing "rapidly" and supporting it with capital are those that are allocating capital primarily to support the balance sheet growth. If your community bank's goal to maintain a leverage ratio of 10% and the strategic goal is to grow total assets by $50 million this year, then that will require $5 million in capital to support it. As we have often mentioned in Musings, capital is a bit of a zero sum game. None of us have unlimited capital (or at least very few), therefore, if capital is allocated toward balance sheet growth, your community bank may need to allocate less capital toward dividends, or distributions if you are a Subchapter S, to your shareholders, or you may simply need to go outside and get external capital.

If your community bank provides adequate capital to support supercharged growth and that growth is profitable, in other words, the bank is putting on high quality and low risk well underwritten loans, then there is no problem with supercharged growth. We have had some clients that have grown in the 15% to 20% range year over year, with no significant issues. (Of course, it does draw some regulatory scrutiny and the bank does need to make sure it has operational support.)

HOW BIG IS TOO BIG?

A question we often get in strategic planning sessions deals with board size (i.e., the number of board members that is appropriate for a community bank board). Board sizes vary. We have a number of family-controlled Subchapter S banks where the Board is basically the family with maybe one or two outside shareholders. That may be five or seven individuals. We have also experienced boards that are four times that size, with 20 plus members.

We often get asked what is the ideal number of board members for a community bank board. Our general response is, the ideal number is the number your community bank needs to have to populate the board's committees and not work the directors so hard they either lose interest or feel like they are not being appropriately compensated for the time they are putting in. We have often found this is somewhere in the seven to 11 range. We have also seen boards effective as large as 13. Once you get beyond that, your board may be getting too large to be manageable.

We also understand the practical issues associated with board size, particularly if your community bank is an acquisitive community bank. Each time you do a deal, particularly if it involves stock, then the target is typically going to want some board representation with respect to the proportionate ownership of their shareholders in the resulting organization.

WHAT'S IN A NAME?

In 2024, we have assisted a number of different community banks with naming issues. We have helped some banks officially change their bank name. We have helped others utilize a "doing business as" name. For banks that utilize a doing business as name, it is important to keep in mind the regulatory requirements related to that strategy.

In the late 1990s, the regulators provided official regulatory guidance on the use of a "doing business as" name. That guidance still stands today. It is basically intended to ensure that customers are not misled as it relates to the identity of the bank and particularly Deposit Insurance. The whole gist of the regulatory guidance is to ensure appropriate disclosures to allow customers to know that the bank is a branch or division of the actual chartered bank, such that they do not have separate Deposit Insurance at two separate banks.

The regulatory guidance generally requires identification of both the doing business as name and the actual chartered bank's name. For example, a bank could potentially operate as "American Community Bank, a division of National Bank & Trust." This would utilize the doing business as name, as well as identify the actual bank name. This naming, along with meeting the other requirements, allow a bank to utilize a doing business as name for marketing purposes while also ensuring customers do not believe they are separately chartered banks with separately provided Deposit Insurance.

Please let us know if you would like us to provide a copy of the regulatory guidance on this issue. We are happy to do so if this is helpful.

NEW REGULATORY PERSPECTIVE ON CAPITAL

The Officer of the Comptroller of the Currency, which regulates national banks, recently issued a Consent Order against a Texas bank. This bank is one of three bank subsidiaries of a Texas bank holding company that also has received an enforcement action from the Federal Reserve. The Consent Order, as most do, requires minimum capital ratios and a capital plan. That is not unusual. What is unusual is that in addition to the standard minimum capital ratios, such as the leverage ratio (which this Order mandates at 10%), a total capital ratio (which this Order mandates at 12%), the OCC also requires the bank to maintain certain minimum ratios going forward, and to calculate the leverage ratio and total capital ratio without excluding the losses represented by the AOCI. Although these ratios in the Order are lower (i.e., leverage ratio of 3% and total capital ratio of 8%) for this bank, it appears it will be very difficult to achieve those ratios.

If any *Musings* readers would like a copy of the capital requirements in this particular Consent Order, please let us know. It is a very unusual situation and hopefully not a harbinger for the future.

FDICIA COMPLIANCE

The majority of community banks across the country have experienced what might be properly characterized as rapid growth over the past five or so years. Many banks have grown 40% to 60% over that time period, with some experiencing even higher growth rates. This has left a number of banks worrying about FDICIA compliance.

If you are not familiar, FDICIA stands for the Federal Deposit Insurance Corporation Improvement Act. It is a set of laws and regulations designed to promote safety and soundness within the banking industry as banks get larger. FDICIA has specific requirements that banks must meet when they exceed $500 million in total assets, and even more requirements when they exceed $1 billion in total assets.

An explanation of the various FDICIA requirements is beyond the scope of *Musings* However, we have a Memo to Clients & Friends that addresses these issues that we would be happy to share. Please let us know if you would like a copy.

A WORD ON M&A

Over the past couple of weeks, we received an email from a widely circulated banking publication that addresses the industry view on bank M&A for 2025. The email indicated the survey results were such that M&A was “prime for a rebound.” Also interesting was a disclosure that 43% of bank leaders indicate their organization is very or somewhat likely to buy another bank by the end of 2025. If that were to come anywhere close to true, that would mean there would be somewhere in the neighborhood of 1,200 to 1,800 banks that acquired at least one or more banks in the next 12 months, which would equate to a loss of about 1,200 to 1,800 banks over the next year, or about 24 to 36 each week. For the record, we believe that level of deal activity to be highly unlikely.

We have had plenty of recent discussions with clients regarding M&A opportunities. We agree there is a healthy dose of current interest in M&A transactions. We also recognize the current headlines about M&A being primed for a rebound to be very similar to the headlines that preceded certain M&A focused banking conferences held in the southwest each winter about 10 months ago. At that time, many banking publications provided that M&A was poised for a rebound, and it seems that is still to be the case.

In our view, a renewed interest in M&A opportunities makes sense. But, the deals are still not easy to complete. The Acquisition Accounting rules still apply, and there are still a number of difficulties in bringing a deal together and getting it closed.

We do view the bank M&A market as thawing. But, we do not think we are out of the woods yet. We are certainly not ready to proclaim 2025 as a year where 1,200 to 1,800 or so banks are acquired. If we are wrong and that does ultimately happen, 2025 will be an absolutely frantic 12 months!

WHEN TO FIGHT

We recently had an interesting discussion with a community bank client about regulatory relations. This particular community bank received some criticism in its Report of Examination that neither we nor the client completely agreed with. It was not blatantly wrong. But, it was not fully correct either.

Our client asked us our views on fighting back against the regulators. Our answer was pretty straightforward: We have no problem picking a fight with the regulators, as long as it is a fight we know we can win or we think has a decent probability of winning. If those are not the circumstances, we recommend taking a somewhat cautious approach in dealing with the examiners on this type of issue.

Of course, this is the proverbial choose your battles. We do not mind battling the regulators at all, provided we are at least equal or have an advantage in the fight. If we do, we see no reason to avoid the fight. If we don't, there are likely other alternatives that may, in the end, produce a better result.

If you find yourself at odds with your regulators, the first thing to do is to get an informed and independent assessment of the circumstances. One that is free of emotion will provide the best clarity as it relates to alternatives and next steps. What we absolutely recommend avoiding is picking a fight with the regulators that is ultimately not successful, because you have wasted both financial and political capital in doing so.

CONCLUSION

We wish all of you and your families a wonderful and relaxing Thanksgiving. We realize that most of you community bankers will be on the job on Friday, so enjoy Thanksgiving Day with family, friends and loved ones, and be thankful you can avoid the "Black Friday" mess.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations

- March 11-14, 2024 – Independent Community Bankers of America - ICBA LIVE 2025 Convention, Gaylord Opryland Resort and Convention Center, Nashville, Tennessee. (Jeff Gerrish, Philip Smith, Greyson Tuck, and Doc Bodine, Presenters) Registration: ICBA LIVE 2025 Convention