GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Texas, Mississippi, Minnesota, Wisconsin, Maryland, Washington, D.C., Virginia, Illinois, and Washington State.

NEW BRANCHES VERSUS ACQUISITIONS

We were recently visiting with a board and senior management group of a community bank that is contemplating an acquisition. The bank had never done an acquisition before and was discussing issues and concerns with respect to integration of the target (a small, rural bank) into the bank's culture, as well as other options such as putting a de novo branch in or near the town where the target was located. Several of the senior executives had been through acquisitions at their prior banks. One in particular stated that the big difference between doing a de novo branch and doing an acquisition is how the key players are involved. In connection with a de novo branch, most community banks follow the strategy of obtaining the "franchise player," getting that franchise player up and running (meaning getting his or her former loan customers into the new bank), and then building the branch around that franchise player. When acquiring an existing bank, all the players are already in place.

This particular executive noted that the major difference is that in connection with the lift-out of a franchise player and his or her support group, they all come willingly, voluntarily, and are excited about it. In connection with an acquisition, the employees do not come willingly. In fact,

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they are forced to come, they generally want the old culture to survive, and for the most part, they did not get any money out of the deal. In other words, they really don't care. This is a major change/difference in perspective that needs to be overcome in connection with an acquisition.

The downside of a de novo branch, of course, is that it will lose money for a few years, where an acquisition, assuming that it is priced appropriately and the earnings stream is solid, should add to the bank's bottom line virtually immediately. Culture issues are important, however, and cannot be ignored in connection with the integration of acquisition transaction.

REPOPULATING EXECUTIVE MANAGEMENT

We have been with a number of banks lately that have a management who can most politely be described as "aging out." An aging executive management puts the board and ownership in a difficult position. Do they want to go through the trouble of repopulating the management or simply sell the bank? Lack of management succession and lack of ownership transition are two of the primary drivers of community bank sales. If you want to avoid a sale and keep your bank independent, then these issues obviously need to be addressed.

The difficulty often, in connection with an aging management and obtaining management succession, is that the bank may not have the appropriate "tools" to do so. We have always taken the position that in order to attract senior executive management at a community bank, the bank must do at least the following: a) pay fair cash compensation, b) have an incentive system that is clear, understandable, and incents whatever the board wants, c) have some type of ability for the executive to get an ownership interest in the company or something that looks like an ownership interest (i.e., synthetic equity, phantom stock, or stock appreciation rights), and d) have something to secure the executive's long-term retirement, such as deferred compensation for the executive supported by bank-owned life insurance. The benefit of this particular item is that it also serves as a golden handcuff for the executive (i.e., if they depart the bank before it matures, they get nothing).

As a board contemplates repopulating the executive management team, it needs to also reevaluate its compensation and benefits structure to make sure it is competitive.

IT'S GOOD ENOUGH

We recently had an interesting discussion with a client regarding CAMELS ratings. We discussed the individual component ratings, particularly asset quality. During the discussion, the

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banker remarked that he would not want to be in a position where the bank was rated a 1 in asset quality because he thought that would reflect too conservative of a lending strategy. Instead, the banker remarked that he would like to be a good, solid 2 because he thought that was the sweet spot for the right mixture of maintaining asset quality and earning interest income.

We cannot say we disagree with this banker's sentiment. We certainly understand why a community bank may want to receive a 1 in asset quality. Many bankers sleep well at night knowing their credits are going to be repaid. However, those bankers might also worry at night about net income or how to increase their loan-to-deposit ratio.

Every point of refuge has its price. As it relates to asset quality, we agree with the sentiment that it does not have to be perfect. We certainly understand that bankers do not intentionally make "bad" loans. But, we do think an appropriate level of risk, with appropriate safeguards, is not a bad spot to be.

FOREST FIRES

We recently had an interesting discussion with a client regarding forest fires. The discussion reflected the idea that some things in life are like forest fires in that it takes multiple people to put them out and it typically does not happen nearly as quickly as anyone would like them to. The discussion was held in light of a recent event at a bank that we are sure the banker would classify as unpleasant. It was a significant and negative event for a bank that took many people to address, and it was not resolved nearly as quickly as anyone would like.

Unfortunately, community banks are not immune to fires. They are going to happen. When they do, our hope is that they are like flash fires and resolve themselves quickly. If they don't, our hope is that the bank is able to keep perspective, perseverance and a little bit of luck. In our experience, with those three things a community bank can make it through just about anything.

EMPLOYEE EMBEZZLEMENTS

There has been much in the news lately about consumer stress, credit card delinquencies, rising prices, and the like. The general sentiment is that things are getting tough out there for many consumers. This idea is also supported by what we classify as the significant increase in fraud that many banks have experienced as of late.

Based on a couple of recent discussions we have had with community bank executives, it appears check fraud is not the only fraud that is on the rise. Unfortunately, we have had a number

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of discussions with banks lately about actual or suspected employee embezzlement. These are situations where the employee has used their position within the bank to gain access to accounts, either through coercion or otherwise, for personal benefit.

What is a bank to do when it either suspects or discovers fraud? Of course, the list is long and detailed, but the general answer can be summed up as: fully investigate the circumstances; if embezzlement has occurred, fire the employee; provide restitution where appropriate; provide initial notice to the bank's fidelity bond carrier; notify the regulators and legal authorities; hire an outside accounting firm to conduct a full forensic audit; make an official claim by submitting a proof of loss under the bank's fidelity bond policy; and pursue legal action against the bad actor.

We hope your community bank is never in a situation where it needs the playbook for how to address employee embezzlement. If you find yourself in that unfortunate situation, you have the playbook at a 50,000-foot level.

A WORD ON FINTECHS

We recently facilitated discussion at a strategic planning session regarding fintech partnerships. This particular planning session briefly kicked around the idea of utilizing fintech partnerships in what is essentially a "banking as a service" capacity. If you are not familiar with banking as a service, the concept is really one that is akin to the bank "renting" its charter to a fintech. Under this setup, the fintech is able to push its product or service through the bank's delivery channels, which effectively gives the fintech access to some of the benefits of being an FDIC-insured bank.

During the discussion, we remarked that, generally speaking, many more fintechs actually need banks than banks need fintechs. Upon making the comment, at least one of the bank employees advocated that we "preach on!"

We are not bashing banking as a service. There are some banks that are doing it well. We are also not saying that community banks should not look to partner with one or more fintech companies. Many of them can provide beneficial products and services. We are simply saying, in our view, the value of a bank charter is significant, and we have experienced many fintech companies that are looking to partner with community banks in order to gain access to the banking system by essentially renting the bank's charter. It is not a bad strategy for a community bank if you recognize what it is and the associated risk.

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CHANGING YOUR PRIMARY FEDERAL REGULATOR

Recently we have had discussions with multiple community banks about whether it would be appropriate to explore changing their primary federal regulator. Some of these banks are national banks looking to possibly be regulated by the FDIC or the Federal Reserve. Several are FDIC regulated banks looking, most likely, to move to the Federal Reserve.

As a practical matter, most of the community banks in the country are state non-member banks (i.e., state-chartered banks that are regulated by the state in which they are incorporated, as well as the FDIC as their primary federal regulator). Virtually all these banks also have bank holding companies that are regulated by the Federal Reserve. The discussion generally involves getting rid of at least one federal regular. The most common migration is from being a state non-member bank to a state member bank. This retains the State as the primary state regular and eliminates the FDIC, but it substitutes the Federal Reserve at the bank level and retains the Federal Reserve as the primary regulator at the holding company level.

It is clear from our experience over the years that the bank regulators from whatever federal agency would be happy to have a bank switch to their jurisdiction. After all, if they do not have any banks to examine, they do not have any jobs. From a strategic standpoint, it is important for a board to consider what is in the best interest of the bank, not just from a financial dollars and cents standpoint, but also from a long-term strategy bank regulatory viewpoint. The process for switching federal regulators for a bank that is rated CAMELS 1 or 2 is not difficult. At your next strategic planning session, it should certainly at least be on the agenda to determine whether there is enough interest to look at it further as part of the ongoing strategic decision-making with respect to the appropriate regulatory environment.

COMMUNICATION, COMMUNICATION, COMMUNICATION

As most *Musings* readers know, members of our firm facilitate dozens of strategic planning sessions for community banks each year. One topic that seems to always come up, no matter the size or shape of the community bank, is communication. Normally, this is discussed as an area in need of improvement for the bank due to its failure to appropriately communicate. Of course, communication is in the eye of the beholder. Often, the executive management team feels like they are communicating or overcommunicating with the employees of the bank, yet the employees often feel that they are not being told enough. A perpetual issue.

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We were recently discussing this communication issue with a community bank in the context of how can the bank improve its culture and the like. Of course, communication was one of the primary suggestions. We heard an interesting "other side" of the communication issue, however, as one of the senior executives referred to over-communication as "death by inbox." In other words, there are so many emails coming in through over-communication that virtually all of them get ignored. Like most things in life, communication is an issue that needs to be kept in perspective and in balance. We need to focus on it but make sure that it is not the be-all and end-all. After all, some things are simply not appropriate to communicate to the masses.

CONCLUSION

Musings should be hitting your inbox at the beginning of the Labor Day weekend. We hope everyone has a wonderful weekend and enjoys friends and family. Fall will be here before we know it.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations

- September 7-9, 2025 – Indiana Bankers Association, 2025 Annual Convention & Expo at the French Lick Springs Resort in French Lick, Indiana. "Staying Rooted: Strategies for Independent Bank Success" (Sept. 8) (Philip Smith, Presenter) Registration: IBA Annual Convention

- September 10-12, 2025 – Community Bankers Association of Oklahoma, 2025 CBAO Annual Convention at the Skirvin Hilton Hotel in Oklahoma City, Oklahoma. "Remaining Independent When No One Else Is" (Sept. 11, 2025) (Philip Smith, Presenter) and "Five Impossible Things Directors Must Do" (Sept. 12, 2025) (Philip Smith, Presenter) Registration: CBA of Oklahoma Annual Convention

- September 10-14, 2025 – Community Bankers Association of Georgia, CONNECT 2025 at the Ritz-Carlton in Amelia Island, Florida. "Critical Information for Community Bank Executives" (Sept. 13) (Jeff Gerrish, Presenter) Registration: CBA of Georgia CONNECT 2025

- September 16-19, 2025 – Community Bankers of Washington, 2025 CBW Annual Membership Convention and Trade Show at The Historic Davenport Hotel, Spokane, Washington "Independence, Directors & Shareholders: Everything You Need To Know!" (Sept. 18) (Philip Smith, Presenter) Registration: CBW Annual Convention

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- September 18-20, 2025 – Community Bankers Association of Illinois, 51st Annual Convention & Expo at the Kansas City Marriott Downtown, Kansas City, Missouri "Ten "Impossible Things Directors Must Do" (Sept. 19) (Philip Smith, Presenter) Registration: [CBAI Annual Convention]

- September 24-26, 2025 – Community Bankers of West Virginia, CEO/Directors Conference at the Stonewall Resort in Roanoke, West Virginia. (Sept. 25) (Philip Smith, Presenter)

- October 16, 2025 – Graduate School of Banking-Madison, Wisconsin (Online Seminar) "Strategies and Planning for Closely-Held and Family Banks" (Philip Smith, Presenter) Registration: [Strategies and Planning for Closely-Held and Family Banks]

- October 20-22, 2025 - Southwestern Graduate School of Banking at Southern Methodist University, National Certified Community Bank Directors' (NCCBD) Program. "Role of a Bank Director" and "Corporate Governance & Fiduciary Responsibilities." (Oct. 20) (Philip Smith, Presenter) Registration: [National Certified Community Bank Directors Program]

- October 26-28, 2025 – Western States Director Education Foundation 48th Annual Symposium for Community Bank Directors at The Grand Hyatt Scottsdale Resort, Scottsdale, Arizona. "What is the Next Chapter for Your Bank?" (Oct. 27) (Philip Smith, Presenter) Registration: [WSDEF Annual Symposium for Community Bank Directors]

- November 13, 2025 - Independent Community Bankers of America – (Webinar) "Preparing Today for Community Bank Leadership Tomorrow" (Greyson Tuck, Presenter) Registration: [ICBA Webinar - Preparing Today for Community Bank Leadership Tomorrow]

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