GERRISH'S MUSINGS

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July 15, 2022, Volume 468

Dear Subscriber:

Greetings from Florida, California, Indiana, Minnesota, Wisconsin, and Ohio!

DOES OUR COMMUNITY BANK MAINTAIN APPROPRIATE CAPITAL?

The question often arises as to an appropriate capital level for a community bank with strong earnings, good asset quality, and otherwise favorable features. The answer depends on from whose perspective the capital ratio is being viewed. If it is being viewed by the regulators (e.g., the FDIC, Forever Demanding Increased Capital) then the capital level will forever be inadequate. If it is viewed by the management of the bank, who has to deal with the harassment by the regulators for having an inadequate capital level, then they would typically opt or argue for an increased capital ratio. From a shareholder's standpoint, lower capital means higher return on equity with the same investment. From a shareholder's standpoint, there would seem to be no need to increase capital unless there is some very good economic and/or regulatory reason to do so. So, what is an appropriate capital ratio for a community bank? It depends on your perspective.

We have had several community bank clients who have recently undergone an examination by their friendly federal regulator. Many of them experienced significant and rapid balance sheet growth during the pandemic. This has done nothing other than lower their capital ratios. We have had a number of them contact us for our advice as to how low they should let the capital ratio go, whether the holding company should inject new capital, and the like. Our general advice is that we have seen the friendly federal regulators give a CAMELS rating of 1 (and a Capital component rating of 2) to community banks that maintain a leverage ratio of less than 8%, provided everything else is working well (i.e., good asset quality, good management, and the like). We reasonably believe if your community bank is somewhere between a 7.5% and 8.0% leverage ratio (obviously not subject to the CBLR) and is otherwise in good shape on all the rest of the CAMELS rating components, then the capital ratio will probably not be a problem. We also believe that below 7.5% leverage will be a trigger for the regulators no matter what, so if you are headed in that direction, it is likely worth being proactive and injecting enough capital to get at least up in the 8.0% neighborhood.

Interestingly, we have talked to many banks recently who simply anticipate their capital ratio rising as their artificially inflated balance sheet begins to shrink. That will certainly solve the problem for some.

HIGH QUALITY, HIGH PERFORMING COMMUNITY BANK

We have had the opportunity over the last several weeks to visit in person with boards of directors and senior management of some very high-performing, high-quality community banks in various parts of the country. These banks are all marked by several common characteristics, starting with exceptional management that has a vision and long-term understanding of the industry and how to make money, as well as a board of directors that does not micromanage but sets the direction for management and then keeps an eye on their execution at a very high level. These banks generally are high-performing from an income standpoint and manage their capital well from a return on equity standpoint. It is always a pleasure to deal with banks that are looking toward opportunities because they have the capacity, rather than dealing with problems reactively.

IMPEDIMENTS TO ACQUISITIONS

We were recently asked by a community bank board of directors to identify what we see as the most significant impediments to acquisitions in the current environment. Our general answer was "the uncertainty" as it relates to the economic and political issues in our country and around the world. However, we do not see this answer as being dramatically different than what we see as the general impediments that are a constant.

Asset quality problems are always an impediment. If you want to prepare your bank for sale (we hope you remain independent), then your community bank needs to improve asset quality so that there is no "hair" on the loan portfolio. Most buyers do not want to take on a problem. If they do, they are going to discount significantly for it.

The primary pricing mechanism in a bank acquisition is the post-acquisition earnings stream acquired by the buyer. In other words, if the community bank is annually earning $4 million today and the post-acquisition earnings increase due to savings on noninterest expense would be $1 million so it would be earning $5 million post-acquisition - then the questions are what is that $5 million earnings stream worth to the buyer, and what does it have to give up (i.e., cash or stock) to get it.

One new wrinkle in the equation, although it does not necessarily impact the earnings stream as such, is the unrealized loss in the bond portfolio. With rising interest rates, that unrealized loss has become significant for many community banks. It can be argued the unrealized loss does not adversely impact the earnings stream, but the problem we are seeing currently is that under the Acquisition Accounting rules, that bond portfolio (as well as all other assets and liabilities of the target) must be recorded on the books of the buyer at fair value as of the date of acquisition. So, from a buyer's perspective, even though they get bonds that will ultimately pay out and make them whole, on the date of acquisition the buyer will take a real hit to capital of the unrealized loss in the bond portfolio. Many will not understand that. For others, it will be a difficult sell to their board, or they will not find it attractive. It is simply a fact of life in the current rising interest rate environment.

REGULATORY ENFORCEMENT ACTIONS

As we have noted in *Musings* often, we see regulatory enforcement actions on the rise. Those actions can be everything from an informal Board Resolution to a proposed Consent Cease and Desist Order. We have recently had a number of community banks contact us about whether they should agree to whatever the regulators are proposing. Although our firm has often willingly and with much enthusiasm fought the regulators on behalf of community banks, we also realize you need to pick your battles. Fighting over an unenforceable document such as a Memorandum of Understanding or a Board Resolution that the bank could actually live with, although it may not be pleasant, probably is not worth the energy. Fighting over something such as a Consent Cease and Desist Order that is subject to civil money penalties for a violation, will stick with the bank for years, and could also be subject to enforcement in Federal Court is a different story. That situation needs to be assessed, and the board needs to be fully informed of the risk of a consent and the risk of litigation with the regulators.

We anticipate it will get uglier out there before it gets better, so understand your rights.

STRATEGIC PLANNING FOR MUTUALS

Over the past couple of months, we have had the opportunity to facilitate several strategic planning sessions for larger community banks that are structured as mutuals. For those that may not be aware, a mutual is a little bit different than a stock bank because the mutual has no stockholders. Instead, the mutual has members (similar to a cooperative) who are the bank's borrowers and depositors.

As we have indicated a number of times previously in *Musings*, the fundamental purpose of community bank strategic planning for stock-owned banks is to enhance shareholder value. For mutuals, the fundamental purpose is just a little bit different. For a mutual community bank, the fundamental purpose is to enhance member value. The difference between enhancing shareholder value and enhancing member value lies primarily with financial concerns. For stock-owned institutions, the central aim is to establish strategies that are intended to make the stock as valuable as possible. For mutuals, the primary purpose is to structure the mutual bank to operate in a way that benefits its primary stakeholders, which includes its customers, communities, and employees.

For these mutuals, the process of enhancing member value was generally summarized as follows:

- Providing financial products and services that are responsive to the banking needs of the mutual's current members and other residents of the mutual's local geographies;
- Supporting local communities;
- Remaining an employer of choice; and
- Ensuring corporate activities support and promote local economic growth.

REGULATION O CONCERNS

We recently received an email from a community bank client that is undergoing a current examination by its friendly federal regulators. The email addressed a very detailed provision of Regulation O. Essentially, the examination team was asking the bank for documentation to prove compliance with the portion of Regulation O that requires an extension of credit to an executive officer to be subject to the condition in writing that the extension will, at the bank's option, become due and payable at any time the officer is indebted to any other bank or banks in an aggregate amount greater than the amount specified for the specific loan type in Regulation O.

In our experience, this is an often overlooked section of Regulation O. Frankly, it is also not an area on which we have seen the regulators focus in the past during an examination. We anticipate that will be changing.

We recommend you give consideration to this provision of Regulation O. For those that may be wondering, it is provided in 12 CFR Part 215.5(d)(4). Anytime you make an extension of credit to an executive officer pursuant to Regulation O, we recommend including the required language in the loan documents. We hope all banks avoid a situation where the examination team finds a "gotcha" on this often overlooked detail in the regulations.

IT'S HAPPENING AGAIN

Every couple of years, we seem to have the same fight with the Federal Reserve. The fight is over what the Federal Reserve sees as a requirement that a stockholders agreement include a termination provision. In summary, the Federal Reserve takes the view that a stockholders agreement needs to expire within 25 years of coming into being in order to not be considered a "company" under the Bank Holding Company Act. In our view, this is arguably the most ridiculous friendly federal regulatory viewpoint they could take. We simply don't see any logical argument that can be made to equate a written agreement among shareholders, which is a contract, as a company for purposes of the Bank Holding Company Act. As we have said before, if the "contract" were to be found a company, it would be impossible for a "contract" to file FR Y-9s, FR Y-6s, and be otherwise treated like a company.

We are, once again, in the midst of this argument with the Federal Reserve. We recently filed a Notice of Change in Control, and the Federal Reserve has indicated that one of the items that needs to happen is for the company's Subchapter S shareholders agreement to be amended to include the required termination provision. The community bank holding company has requested that we push back against the Federal Reserve on this issue. We are in the midst of doing so. We will keep you updated and let you know if we are successful in convincing the Federal Reserve that the termination provision is not absolutely required.

MANAGEMENT INTERLOCKS

We recently had an interesting discussion regarding management interlocks. If you are not familiar, "management interlocks" is the regulatory term for an individual that serves as a director or executive officer in banks that operate within the same general geographic location. This is not all that uncommon of a situation, particularly in rural parts of the country where executive talent is more difficult to attract and retain.

The general rule is that management interlocks are prohibited. However, there is an exception to the general rule for smaller bank holding companies. The exception is generally referred to as the "small market share exemption." This allows a management interlock if the total assets of either bank do not exceed $10 billion and the depository organizations hold, in the aggregate, no more than 20% of the deposits in the relevant markets. There are also exemptions that allow a management interlock if the FDIC finds that the interlock would not result in monopoly or substantially lessen competition and would not present safety and soundness concerns.

Keep in mind the general rules related to management interlocks, as well as the applicable exceptions. It may be that these exceptions are able to help you out in some way.

CONCLUSION

Summer is clearly here in virtually all parts of the country. Things are heating up nicely, and many of you are headed to the mountains or the seashore for a vacation. Enjoy the time with family. Stay safe.

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

