GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from "working remotely"!

THE PERFECT STORM – OR IS IT?

As most *Musings* readers are aware, most of the largest publicly-traded banking companies are in the midst of their first quarter earnings releases. Many of these companies are making whopping provisions to their allowance for loan and lease losses. We were recently reviewing one such report and noted the bank had made a provision that was approximately 130% of the bank's first quarter earnings in the prior year. This bank had $112 million in earnings in the first quarter of 2019. This year they earned $16 million in the first quarter. Part of that is because they set aside $145 million (about 130% of what the bank made in the first quarter of last year) because of CECL and COVID-19. Although we are sure these provisions are "legitimate," we also wonder whether some of these banks are making these extra large provisions because the current environment shelters them from additional adverse fallout. The situation is akin to one of these big banks bringing in a new CEO who cleans up everything in the loan portfolio just so it does not happen on his or her watch. We think we may be seeing a little bit of that. In other words, let's take advantage of the bad issues going on in the economy to clean up our portfolios. There may be some "sandbagging" going on. We will see.

VIRTUAL ANNUAL SHAREHOLDER MEETINGS

We have assisted many community bank clients around the nation with respect to addressing best practices for virtual annual shareholder meetings. The first place to start is to review whether the Articles of Incorporation and Bylaws for your holding company or bank (if you are without a holding company) allow for electronic or virtual meetings. A review of state law would also be appropriate.

Due to the recent pandemic for certain, both large banks and small banks are holding virtual meetings. Some of them go off without a hitch, and some of them have some technical difficulties. We read with interest recently about Citigroup's annual meeting held April 21st. It appears that even the Citigroup meeting had some technical glitches with respect to the ability to communicate with various executives who were in the room.

We know one advantage of electronic meetings is that the bank can control the flow of the meeting, as well as the participants. It is also an advantage to get participants who may want to participate but could not otherwise physically be present - i.e, those out-of-town or out-of-state. We anticipate many of next year's meetings will be held virtually as well. We also anticipate that the technology will get better, as well our familiarity with its use, to provide for smoother annual meetings. In this environment, where many banks are moving for the first to a virtual meeting out of necessity, we generally recommend that the meeting be kept "short and sweet." This may mean only a vote on directors or the approval of auditors, which you normally do, without a lot of discussion and reporting by officers and the like. It is also necessary to provide a mechanism for shareholder discussion as part of your virtual meeting, so don't forget that.

PPP LOANS AGAIN

One issue we raised in the last *Musings* about PPP loans has been clarified by the SBA in question 31 of the SBA's Frequently Asked Questions regarding PPP Loans. The issue raised in Musings was the borrower's required certification that "Current economic uncertainty makes this loan request necessary to support the ongoing operations of the applicant." In the last Musings we focused on this issue in general and the concern that some borrowers cannot in good faith make this particular certification. This came to a head in the past week when it was revealed that some large companies, like Ruth's Chris, received PPP money when they had access to other funds.

The SBA's solution on this is to remind the borrowers they have to, in good faith, make a certification. SBA notes that it is highly unlikely that a public company (and some private companies) with access to the public capital markets or other liquidity could make the certification. Finally, the SBA notes that if one of these companies borrowed the money and their certification was, as a practical matter, false, the company may repay the money by May 7, 2020 without penalty - no harm/no foul. The SBA notes that that will be deemed by the SBA "to have made the required certification in good faith." It will be interesting to see how many companies repay the money prior to May 7th in order to avoid the potential criminal issues associated with a false certification under the PPP Program.

PPP BORROWER LIABILITY

Please note that the Treasury has also announced that every PPP borrower in excess of $2 million will have their PPP application and use of funds audited prior to the SBA forgiving the loan.

This issue is important for community banks. What is also important are the comments by Secretary Mnuchin that the borrowers that fraudulently made these certifications will be held accountable. The concern we relayed last week is that lenders may be liable under some circumstances. We continue to hold the same concern but have some hope, at least based on the Secretary's recent comments, that the Treasury and SBA will look to penalize the borrowers and not the lenders in cases of fraud or abuse of the program.

MATCHING REVENUES AND EXPENSES: GOOD NEWS AND BAD NEWS

Many community banks will recognize a significant increase in non-interest income as a result of the origination fees received on PPP loans. This is certainly welcome news. However, it is no secret that the PPP program is in place as part of the government's efforts to stave off a complete and total economic meltdown. Given the circumstances, it is likely that most banks will also see a need for an appreciable increase in their Allowance for Loan and Lease Losses.

Many community bankers we have visited with over the last couple of weeks are looking to match these one-time revenue increases and one-time (hopefully) extraordinary expense provisions. In other words, they are taking all or a portion of the found income from the PPP loan originations and using it to offset the expense associated with further increasing the Allowance. The hope is that this will allow for banks to increase their reserve while still maintaining appropriate net income and meeting or getting very close to budget.

If you have not done so already, give this revenue and expense matching strategy some thought.

LENDING LIMIT ISSUES

We have received numerous calls and emails over the last two weeks about lending limit issues and how they interact with PPP. This brief *Musings* article is not intended to provide legal advice, but the general framework is that because PPP loans are, as a practical matter, "guaranteed by the U.S.

Government," they are excluded from the national bank legal lending limit and most states' as well (but check your state). Also, a PPP loan to a director, which is now permissible as long as that director does not own greater than 30% of the company, is also excluded from the Reg O lending limit based on the same theory (i.e., Government-guaranteed). If any *Musings* readers need any specific information as you go through the PPP issues over the next couple of days, please let us know.

M&A DISCUSSIONS

Many of the states around the country are beginning to take steps towards "reopening the economy." This is essentially the thaw from the freeze, as it will be a gradual and phased-in process of returning to some sense of normalcy largely based on the region's ability to contain the spread of the virus. As these markets begin to reemerge from the lockdown, so too have bankers' interest in resuming discussions on M&A activities. We have received several calls over the past couple weeks from bankers that want to essentially "pick up where we left off" relative to M&A discussions.

As we continue to move forward in navigating the uncertainties, there are a couple things that we think are particularly pertinent to the continued evaluation of M&A activities. The first is pricing. It is important to know that a way a deal is priced <u>has not</u> changed as a result of this pandemic. It is today, as it always has been, a function of earnings and return on investment. Simply put, the price an acquirer is willing to pay is directly related to the increase in earnings that will be enjoyed after the acquisition.

The second issue is, not surprisingly, one of due diligence. This directly impacts the pro forma earnings and return on investment. It is important to closely review the target bank's asset quality and potential losses. Obviously, a buyer wants to avoid situations where they experience unexpected losses after closing since that is a de facto increase in purchase price.

The level of community bank M&A activity is not back to pre-crisis levels. However, it is not completely dead either. There are many banks that are still looking for opportunities in light of the pandemic. What also has not changed is the importance of understanding how to price the transaction and properly complete due diligence.

LOOKING ON THE BRIGHT SIDE

Over the past couple of weeks, we have had discussions with several community bankers that we believe have an appropriate perspective on the entire pandemic. Each of these community banker's banks generated a significant level of PPP loan originations. The increase in non-interest income of course was viewed as a positive. However, that was not what these community bankers viewed as the crown jewel of the pandemic. Instead, these community bankers discussed the multiple opportunities their banks have had to assist new customers in obtaining PPP funds when their larger banks failed them in that regard. These bankers indicated that in their respective communities they have had one or several prominent businesses that could not get any appropriate response from a regional bank, so they came to the community bank and had their PPP loans approved in a few hours. This was so impressive that these business individuals spread the word to all of their other business friends in the communities. In a time of three to four days, these community banks had the opportunity to serve multiple new business customers that were all key constituents in their respective communities. By all accounts the interactions were great, so the expectation is that these will not become one-time customers but will instead become long-time relationships for these community banks. Without the pandemic and PPP, these community banks may very well have not had the opportunity to showcase their talents in a once in a lifetime audition.

THE TRUE MEANING OF "CHARACTER"

Those of you *Musings* readers who have kids or grandkids know that often the issue of character comes up. This is typically when the kid does something he or she shouldn't have done and you want to give them a little wisdom/discussion.

We were always taught that the true meaning of character is to do the right thing, even when no one is looking. In this environment, it seems the true meaning of character is, of course, not only to do the right thing when no one is looking, but to do the right thing when times are tough. If you made commitments in the good times and now the tough times make those commitments more difficult to fulfill, shouldn't you still fulfill the commitment? That is the true meaning of character. We are pleased to see a lot of true character coming forward through the pandemic. This is everything from charitable donations to food banks for families who are "food insecure" to the support for first responders. It applies as well in the banking business with bankers working 24/7 to get the PPP loans out to their small business customers. Just keep in mind the true meaning of character is doing what you say you are going to do in good times or bad.

CONCLUSION

After a month or more of lockdown, we are looking forward to a somewhat return to normalcy. It appears that although COVID-19 has not, by any means, disappeared, our collective abilities to manage the issues associated with it appear to have significantly improved. With many of the states phasing in their return to normalcy, we look forward to further visiting with many of you, even on a face-to-face basis.

In the meantime, stay safe and healthy and enjoy your families. See you in two weeks.

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