GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from "working remotely"!

PPP FRAUD

As most *Musings* readers expected, not all PPP borrowers are angelic good citizens. The first fraud case brought by the Inspector General in combination with the Department of Justice has already occurred. It involved a couple of PPP borrowers who decided to borrow some money to support, in one case, a business that didn't exist, and in the other one, a business that had been closed down long before the term "COVID-19" had even been coined. These borrowers applied for more than a half million dollars. Based on our sources, the borrowers were turned in to Justice by some pretty astute bankers who, before making the loan, drove by one of the establishments on which the loan was to be made, and found out it had not been in business for years.

We have generally found that defrauding the government does not go well for the perpetrators. We expect that will be the case here. If anybody would like a copy of the Inspector General's press release, please let us know.

LENDER'S OBLIGATION UNDER PPP

For the last couple of weeks, we have gotten a number of inquiries from community bank clients across the nation about the community bank lender's obligation to make sure that the PPP borrower is not inappropriately or not in good faith providing the certifications required for the PPP loan. The most significant certification, which we have noted previously in *Musings*, requires the borrower to certify that "current economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." The question is, what is the community bank's obligation if they think a borrower either does not understand the certification or may be making it in bad faith? If it is criminal, then the bank has the obligation to turn the borrower in. If it is questionable, the real issue is does the bank have the obligation to counsel the borrower? We have noted that some banks have used their social media outlets to generally advise the public that this issue exists. We are not sure we endorse that approach. The real question is, if you have a good borrower and you think they may be overstepping the line, do you contact them? Our general advice is to look at this entire PPP loan issue as anyone with 20/20 hindsight would look at it. If a borrower gets caught in a squeeze and you had not helped that borrower, is that a problem? If you don't help one of your best customers and that customer gets criticized (or worse) by the SBA or the Department of Justice for taking the PPP loan, will the bank be criticized for that?

Also, on May 13th, the SBA added a Frequently Asked Question to their list of FAQs. This one, number 46, indicates that with respect to any PPP loan under $2 million to a business (including its affiliates), the borrower will be "deemed to have made the required certification concerning the necessity of the loan request in good faith." This provides a safe harbor for PPP borrowers for loan amounts of less than $2 million. In addition, FDIC Chairman Jelena McWilliams in her testimony to Congress this week again emphasized that the responsibility of the PPP program is on the borrower, not the community bank lender. Hopefully, that will give all some comfort.

Unfortunately, there are no right answers to this, and each situation will be different. Nonetheless, it is an issue that we need to consider, even though the automatic date for a certification being deemed to be not fraudulent if the PPP funds are repaid, as a practical matter, is May 18th.

SHARE LIQUIDITY

We have received a number of contacts from community bank clients across the nation lately about their shareholders' need for share liquidity. Some of this is generated by the difficult short-term (we hope) economic issues we are facing. Some of it, though, is simply long-term needs for liquidity.

For most community banks, market liquidity does not exist. Even many of those listed on NASDAQ or the OTCQX do not have any appreciable market liquidity. It is incumbent upon most community bank holding companies to create that liquidity for their shareholders. This simply involves a capital allocation issue. Does the community bank board determine to allocate capital to create liquidity, to provide a dividend or distribution, to support growth of the bank, or to all of the above? Creating share liquidity is an obligation of the board to enhance the value for its shareholders in order to keep the bank independent. The discussion of creation of share liquidity should be part of every planning session.

IMPACT OF COVID-19 ON THE LOAN PORTFOLIO

We have been asked by a number of community bank clients around the country as to our thoughts on the impact of COVID-19 on community bank loan portfolios in general. Many of the community banks we have visited with have felt no impact on their loan portfolio whatsoever - very few requests for forbearance, no missed payments, and the like. For some of these banks, the lack of impact on the loan portfolio is due to the fact that many of their loan customers are essential workers (i.e., hospitals and the like) where they are not only working, but they are working overtime.

Our experience has found that each community bank is different. For some of the community banks, COVID-19 will have a tremendous impact on their loan portfolio. These community banks will need to make a significant provision to their allowance for loan and lease losses. Other community banks may find the need not to make any provision to speak of. Each community bank will, we assure you, be different in this regard. Keep an eye on yours, and make sure whatever that provision is, it is justifiable.

Musings readers have probably noted that the large banks and the large regional banks have made what can only be described as “whopping” provisions. As we have indicated in prior *Musings*, we think they did this primarily because they could – “let’s make it a bad quarter if it’s going to be bad quarter.” Community banks do not need to play with the market that way, so we really need to assess our asset quality in a realistic manner.

MATCHING REVENUES AND EXPENSES

The last edition of *Musings* mentioned a number of community banks taking the strategy of matching all or some of the origination fees from PPP loans to provision expenses to increase the Allowance for Loan and Lease Losses to increase the reserve in light of the pandemic. We heard from a number of different community bankers related to this past *Musings*. Many confirmed that strategy. However, a number also introduced a similar, but distinct, revenue and expense matching strategy.

Many community banks we have heard from have indicated they are going to take a portion of their PPP loan origination funds and pay those to the employees working on the PPP program as a special bonus. This is a token of gratitude for the significant time and effort put forth by these employees to serve customers over the past four to six weeks. We have heard many stories about community banks having teams working around the clock to input PPP loan information, since it seems E-Tran apparently works better at 3:00 in the morning than 3:00 in the afternoon.

In our opinion, kudos are appropriate all the way around in these situations. These employees certainly deserve recognition and appreciation for their extraordinary efforts to serve their customers. These employers also deserve recognition for proving that community banks are the employer of choice in communities all across the nation.

PPP LOAN FORGIVENESS

When the PPP program was first announced we raised our concerns related to fraud in the program. We noted our belief that may borrowers were treating the PPP program as a government giveaway, regardless of actual borrower need. We also noted our concern that either the SBA or a borrower may look to assert liability against a lender when the borrower's PPP loan was not forgiven in full.

Apparently our concern is not completely without merit. Over the past six weeks or so, the issue of fraud within the PPP program has come front and center. As mentioned elsewhere in this *Musings*, the latest development is essentially a classifying of loans over or under $2 million. According to the SBA, any PPP loan in excess of $2 million will be audited for compliance with the required borrower certifications prior to being forgiven. Any loan of less than $2 million is presumed to properly satisfy the borrower certification requirements. Of course, the SBA always has the ability to review these loans regardless of the presumption.

Unfortunately, we do not think the PPP fraud issues are going away soon. The SBA has given guidance that lenders are able to rely on borrower certifications. However, the risk still remains that borrowers who do not receive full forgiveness are, at best, disgruntled customers or, at worst, future plaintiffs in a lawsuit seeking to shift their liability of the loan to the originating bank.

REGULATORY APPROVALS FOR ACQUISITION TRANSACTIONS

We recently read with interest an article announcing that the largest ever credit union acquisition of a bank has failed to be completed, apparently thanks to COVID-19. The article, quoting a statement from Apollo Bank in Miami, Florida, which was the community bank target to be sold to a credit union, referenced "a series of indefinite delays that arose during the regulatory approval process due to the COVID-19 pandemic." Based on our reading of the article, as well as our understanding of the regulatory approval process, our assumption is that COVID-19, which has hit Miami hard, made the deal considerably less attractive for the acquiring credit union than when it was struck, and the parties, or at least one of them, used the regulatory approval process as an out on the deal since the transaction can only be consummated following the receipt of all required regulatory approvals.

We are currently going through a couple different regulatory approval processes for various transactions around the country. The current environment has led the regulators to ask a number of additional questions, all tying back into the effects of COVID-19. Notwithstanding these additional questions, we do not believe there is any type of regulatory moratorium on transaction approvals.

As it relates to the current regulatory environment, our approach has generally been to work with the regulators and acknowledge there is some uncertainty as to the exact impact of COVID-19. However, we have had the most success in responding to the regulators with what we see as best case and worst case scenarios. We are essentially providing the regulators financial projections that show both a best case and a worst case scenario. Importantly, the financials prove that under either of these scenarios the transaction is one that is approvable. We think this makes the most sense given the uncertainty of today's environment.

NON-COMPETE AGREEMENTS

We are currently working with several community banks that are looking to diversify geographically and enter into new markets. As noted in prior *Musings*, the best strategy for this is to look to hire the "franchise player" within the market the community bank desires to enter. This follows the strategy of why build it when you can buy it.

An issue that always comes up in these types of situations is that of the necessity of a non-compete agreement. Of course, the franchise player does not want a non-compete because the bank is coming into their home turf, and if they get a better offer down the road they do not want to be restricted by this type of agreement. For the community bank entering the new market, we view the non-compete as essential. If the community bank is going to invest the time and money to hire the franchise player and build out the market, it deserves for that investment to be protected.

Any time you are looking to hire franchise players, be sure you stick to your guns on non-competes. It is necessary in order to appropriately protect the bank's investment in building out the new market

CONCLUSION

With most part of most states in the country opening up from the COVID-19 lockdown, we are again receiving numerous requests from clients for face-to-face meetings. We are happy to oblige. We are also happy to utilize one of the videoconferencing services that we have used so much over the last couple of months – Zoom, GoToMeeting, Starleaf, and others. The important thing is that all of you, your families, your customers, and employees stay safe.

See you in two weeks.

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