# GERRISH'S MUSINGS

Jeffrey C. Gerrish
Philip K. Smith
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
♦ Phone: (901) 767-0900 ♦ Fax: (901) 684-2339 ♦
♦ Email: jgerrish@gerrish.com ♦ psmith@gerrish.com ♦ gtuck@gerrish.com ♦
Website: www.gerrish.com

June 15, 2020, Volume 418

Dear Subscriber:

Greetings from West Virginia, Illinois, Georgia, Alabama, Tennessee, and Florida!

## HOW NOT TO RESPOND TO THE EXAMINERS

We recently read with interest a press release from the FDIC's Office of Inspector General with respect to a community bank president who pled guilty to fraud and arson. Apparently, this particular community bank president had over the last eight years or so created numerous nominee loans – some under the names of actual customers and some apparently totally made up. In 2019 when the bank was scheduled for an examination by its friendly state regulators, the Bank President piled the files related to nominee loans on the boardroom table and lit the entire thing on fire. Although the files burned up, it did not change her probability of getting caught. She misappropriated over $11 million in bank funds over the eight year time period and will have the opportunity to serve 84 months in jail. The moral of the story is: Don't try and burn down the bank to keep the examiners from finding something. If anybody wants a copy of the press release, please let us know.

## AN UPDATE ON EXAMINATIONS

Over the past couple weeks, we have had a number of discussions with community bankers that either just completed or were in the midst of an examination. All of these are continuing to occur off-site. The regulators are doing all of the work remotely, and examination meetings are occurring via telephone, videoconference, and the like. It will be interesting if that continues for the State, the FDIC, and the Federal Reserve. The new Interim Comptroller of the Currency has already indicated that their examiners are "itching" to get back to the national banks.

Of note related to these examinations is the fact that each of these bankers generally relayed that they thought the examination was appropriate and that the examination team did not spend as much time focusing on COVID-19, borrower delinquencies, forbearance requests, and the like as was anticipated. The general consensus, at least as we are hearing it, is that the examiners are pretty much focusing on the "as-of" examination dates, which are generally pre-COVID. This is certainly welcome news on the regulatory front. Unfortunately, we do not anticipate this trend will continue. At some point in the not too distant future all of this is going to come home to roost, and we think the examination environment will get tougher. We even had one of our clients indicate their examination team told them as much during their exit meeting.

The examiners have given a lot of lip service to the amount of regulatory forbearance that will be given for COVID-related issues. We have noted before that our concern is a "yes, but…" regulatory environment. Essentially the on-site examination team saying that yes, they recognize the regulatory guidance said this, but for whatever reason, we are treating it differently. We would love to be wrong there, but history leaves us placing our bets closer to that than it does actual regulatory forbearance.

## ANOTHER TAKE: THE FRIENDLY FEDERAL REGULATORS

Since the beginning of the pandemic, the friendly federal regulators have been making various pronouncements with respect to forbearance and other expectations of community banks. These pronouncements are providing great "lip service" to the regulators' new and improved attitude as it relates to the adverse impact of the pandemic on certain community banks. We have had, however, calls from a couple of CEOs of community bank clients in the last couple of weeks whose community banks are undergoing exams by the friendly federal regulators and finding them to be none-too-friendly. Often, the situation involves a young new examiner trying to make his or her chops on the community bank. One situation in particular involved a high-performing community bank doing everything right that is now receiving demands from an inexperienced examiner to take various actions as it relates to not only their loan portfolio, but also processes and procedures, that only border on the absurd and will cost the community bank a significant amount of money. For both these situations, we have gone back and "dusted off" the friendly federal regulators' appeals process with the idea that it may be necessary if normal pushback through appropriate channels does not solve the problem.

Keep an eye on the difference between the examiners actually in your bank and what the agency heads are saying, which apparently, based on our anecdotal experience, is not filtering down to the examiners in the field. At least not most of them.

  

## DEPARTMENT OF JUSTICE AND THE PPP

As we have mentioned in prior *Musings*, we are firm supporters of the PPP program, the positive effect that community banks lending to the small business customers in their communities have on their communities, and the benefit to the community bank from the fees received on the low risk loans. We have noted in *Musings*, however, that we do not believe that all these benefits come without potential exposure. Over the last two weeks, at least one community bank has announced that it has received "a civil investigative demand from the U.S. Department of Justice directing it to produce information on its Paycheck Protection Program lending activities." In other words, this particular community bank is being investigated in connection with the PPP loans. Because they are a public company, they were required to disclose the investigative demand of the Department of Justice. This one is above the radar. We do have some concern about some of the community banks that may be below the radar yet getting the same treatment from Department of Justice. Just a note to all to have appropriate expectations as to what may result from the PPP program. If anyone would like a copy of a brief article with respect to this, please let us know.

## DEPOSITS GALORE

We recently had an interesting conversation with a community bank CEO that is considering a number of different strategic alternatives. This particular community bank has seen an incredible increase in deposits over the last three or so months. More specifically, their total deposits have grown by about 20% over this time period. Our discussions with this CEO involved how to put these deposits to use.

We talked about a number of different alternatives for the deposits. The ideal situation would be to loan them out to further increase the bank's net interest margin. Unfortunately (and not surprisingly), the bank's loan demand is not following the same trend as these deposits. We talked about a number of other unique uses for the cash, such as buying subordinated debentures of other bank holding companies, buying securities, making alternative investments, and the like.

The central issue relative to the deployment of these deposits is one of risk management. Given the rapid increase in deposits, there is a concern that the outflow might be just as quick. Obviously the asset liability management component is key because they do not want to get into a liquidity crunch.

We suspect there are many community banks that are dealing with the issue of what to do with excess cash. Certainly you want to put it to work, but be certain to do so in a way that maintains the principles of risk management. Our concern is that the withdrawal of these deposits may be just as quick as them coming into the bank, and you certainly want to avoid any liquidity crunch by getting too aggressive with the investment of this cash.

## RENEWED INTEREST IN ACQUISITIONS

We would describe the community bank mergers and acquisitions environment as very active prior to COVID-19. Beginning at about mid-March, things slowed considerably. Many of the deals that were in the works were put on hold, and there were virtually no community banks that were looking at trying to bring new deals together. Now, almost three months past the initial lockdowns and the like, that tide seems to be changing.

Over the last few weeks, we have assisted a number of clients in looking at potential cash acquisition opportunities. We have "run the numbers" on a number of potential deals where buyers are thinking about trying to make a strategic acquisition. We think this is important, as it represents community bankers that have enough confidence in their bank and their balance sheet to be thinking from an offensive strategic perspective.

The level of M&A activity is not back to pre-pandemic levels. This is primarily because for the large players with publicly traded liquid securities, the stock prices have not recovered. However, at the community bank level, the interest in cash acquisition activity is increasing. We see that trend continuing, particularly if there is not a significant "second wave" of virus transmission and shutdowns.

## ESOPs AND KSOPs

You will not be surprised to know that there has been somewhat of a slowdown in community banks looking to engage in strategic transactions since COVID-19. These have not stopped altogether, but they are not occurring at the pace they were prior to the pandemic. One area that we believe is an outlier in this regard is the establishment of ESOPs and KSOPs. As we see it, this is an area that is as active as ever. We are currently working with a number of different clients to develop and implement ESOPs or KSOPs for their community bank.

Why is it that these employee benefit plans seem to be gaining momentum following the crisis when other strategic transactions are not doing the same? We believe it is because of their versatility and benefits. These employee benefit plans can be used to increase bank capital in a number of different ways, including through existing 401(k) funds or leveraging the ESOP/KSOP. They also serve as an additional avenue for shareholder liquidity for shareholders that may need or want to sell their shares at a fair price in a timely manner. They also serve as a great employee attraction and retention tool by putting in place coveted "golden handcuffs," particularly for those employees that have been there a long time.

Overall, we see the benefits of ESOPs and KSOPs as significant. Please let us know if you would like additional information on their operation or how they might be beneficial to your community bank.

## COVID-19 ACQUISITION ISSUES

As noted above, acquisitions in March came to somewhat of a screeching halt but are now beginning to pick up, particularly on the cash side. Similar to coming out of the Great Recession, as we progress through the COVID-19 pandemic, banks in the acquisition arena need to make sure they understand the risk associated with the impact of COVID-19 on the target bank (and their own bank). As following the Great Recession, this again focuses primarily on asset quality issues for the target. Can those issues be identified? Do they need to be segregated and escrowed against the purchase price? Should the assets actually be transferred to the shareholders? Each of these risk mitigation issues and others should be considered in connection with the acquisition of a bank during the COVID-19 pandemic.

As noted above in *Musings*, we do not anticipate that acquisitions will stop. In the community bank space where the buyers are using cash, we believe many banks will view the current situation as an opportunity to pick up banks who continue for mostly the traditional reasons to want out (i.e., lack of management succession, lack of board succession, older shareholder base, need for share liquidity, and the like).

## CONCLUSION

As you may note from the "Greetings" line in this *Musings*, we are back on the road again. We look forward to seeing many of you in the coming weeks and months at your bank.

Don't forget your fathers on Father's Day, June 21st. Have a great two weeks.

*Jeff Gerrish* *Philip Smith* *Greyson Tuck*

  