GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Iowa, Minnesota, Wisconsin, Georgia, Florida, Arkansas, and Tennessee!

WHO EXAMINES THE EXAMINERS?

Who examines the examiners? That is, who looks over the shoulder of the friendly federal banking regulators on how they perform their jobs? The answer is that each agency - FDIC, OCC, and the Federal Reserve - has an Inspector General. This is the internal agency watchdog. The FDIC's internal agency watchdog, the OIG, regularly publishes the results of its "examination" of various parts of the FDIC. The most recent report was on the FDIC's Sexual Harassment Prevention Programs. The OIG concluded "We found the FDIC had not established an adequate sexual harassment prevention program and should improve its policies, procedures and training to facilitate the reporting of sexual harassment and address and report allegations in a prompt and effective manner." It is good to have somebody examining the examiners. If you do not like what the FDIC examiners do in your bank, you may like what the Inspector General does to the FDIC in his reports. If anyone wants a copy of this report in particular, please let us know. Otherwise, you may want to get on the press release listing for all the FDIC OIG reports. They are generally pretty interesting.

ECONOMIC OUTLOOK FOR 2020 AND BEYOND

As part of a recent planning session, our high-performing community bank client brought in (via Zoom) a well-known economist who focuses on community banks. This particular economist gave an excellent one-hour presentation. To sum it up, although feeling strongly that the recovery will be in the nature of an "L" - i.e., much slower than anticipated by many - and not a "V" – i.e., a fast recovery - he also significantly acknowledged that the second and third quarters of this year are "cloudy" at best. In other words, it is very difficult to determine from the data what is going to occur. Sounds like an honest economist to us.

INCREASED M&A ACTIVITY

Recently we had the opportunity as part of a planning session to listen to an hour discussion by one of the big investment banking firms. This community bank had brought them in to talk about the merger and acquisition landscape. We thought it was interesting that this particular "name" firm felt that mergers and acquisitions had dropped off the cliff, that there was no activity, and they did not anticipate there being any activity.

After listening to the usual "you can't survive at the size you're at" speech and hearing how dead the M&A market was, we basically disabused the board of that notion. For the large banks who pay sellers with stock and whose stock price is depressed, of course M&A has fallen off the cliff. Those large publicly-traded banks do not want to give out a bunch of low-priced shares. Our experience, however, in dealing with the community banks, most of whom are cash buyers and cash sellers, is that merger and acquisition activity, while hitting a short pause during the pandemic, is now top of mind for most community banks. Just in the last few weeks, we have been asked by multiple organizations to "run the numbers" on potential acquisitions of target banks. We see this as a positive. It means that the boards of directors are looking beyond the short-term pandemic implications, and more toward long-term enhancing shareholder value.

REGULATORY EXAMINATION ISSUES

We were visiting the other day with a client who had recently concluded an examination. The good news was that the bank did fine on everything, but the regulators knocked the Asset Quality component rating of the CAMELS rating from component rating of 1 to a component rating of 2. Keep in mind each of the components of the CAMELS rating – Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity - get separate ratings. This particular client was upset that the friendly federal regulators had knocked the Asset Quality rating down from a 1 to a 2.

Our comment was basically that we honestly foresee very few component 1 ratings for Asset Quality within the CAMELS structure for the foreseeable future. We believe the friendly federal regulators in particular will view the uncertain economy as a leverage point to knock any Asset Quality from a 1 to a 2. We believe that 1's in Asset Quality will be rare. Keep that in mind at your next exam.

COVID-19 – A DISEASE OF CONVENIENCE?

We were recently assisting with a planning session for a high-performing community bank. One of the participants in the session discussed the impact of COVID-19 on his life - both business and personal. In part of the discussion, he indicated the impact was significant on his elderly parents, particularly his father, although he primarily used COVID-19 as a "disease of convenience."

What he meant was that if his father wanted to go out and play golf with his buddies or go to the local watering hole, it was fine. However, anytime his father had someplace he did not want to go, such as church or to the grocery store, he couldn't go because of COVID-19. We have never heard COVID-19 being described as a "disease of convenience," but it sure seems to apply in this case.

SALE OF PPP LOANS

We have had a couple different conversations with community bankers that have been approached over the past couple weeks about the potential sale of PPP loans. The story from the bankers is generally the same. They receive a call from a representative of a hedge fund or private equity group in New York, LA, or some other big city that is looking to purchase the SBA guaranteed loans. The offered purchase price is typically about 98% of face value of the loan, along with a promise that the transaction will be incredibly simple for the selling bank. The other sales "hook" from the interested buyer is to remind the bank that the buyer will take care of all aspects of receiving forgiveness on the PPP loan. The pitch to the selling bank is that it will simply sell the loan for cash and then have to do nothing further.

The bankers we have spoken with have indicated the pitch initially sounds somewhat appealing. However, on further thought, every community banker we have spoken with has indicated they are taking a pass. Why? It all ties back into the customer service issue. Simply put, the community bankers we are talking with are not comfortable with turning over their borrowers (even new ones) to a hedge fund or private equity group to rely on them for the PPP loan forgiveness process. The concern is quality of service and the community bankers' belief that any shortcomings by the hedge fund will ultimately reflect poorly on the community bank.

STOCK REPURCHASE TRANSACTION DISCLOSURES

Our previous edition of *Musings* touched upon the Federal Reserve's prohibition on stock repurchase transactions by the nation's largest banks. As noted in the previous *Musings*, this share repurchase restriction is not applicable to community banks and their holding companies. This means that community banks are free to engage in share repurchase transactions the same as they always have been, notwithstanding the issues related to COVID-19.

Community bank holding companies that are considering or already engaging in share repurchase transactions in this environment should keep in mind the disclosure issues related to a share repurchase transaction, whether driven by COVID-19 or otherwise. It is important for any holding company that is engaging in a share repurchase transaction to disclose to the seller the information it may have relative to COVID-19 and the effects, positive or negative, it may have on the bank's business and holding company stock. The requirement is essentially that the buyer and seller have parity of information and that neither party have material, non-public information that is not available to the other.

Along the same lines for consideration related to required disclosures is that of insider trading issues. If your corporate directors or officers have material, non-public information related to the effects of COVID-19 on the bank, those directors and officers need not be trading in the stock without making that information known to the counterparty.

Each individual circumstance warrants its own approach. However, the general theme that should be followed is one of disclosure. It is important that each of the buyer and seller have parity of information in a transaction in order to avoid violations of the insider trading rules.

COMMUNITY BANK STRATEGIC PLANNING

Over the past couple weeks, we have had multiple one-on-one and group discussions regarding community bank strategic planning. Some of these discussions have been true, day-long strategic planning sessions. Others have been discussions focused more on reviewing and refining an existing strategic plan. One of these discussions recently struck us as interesting because it was essentially strategic planning by process of elimination. The bank did not know exactly what they wanted to do in this environment, but they certainly knew the strategies they had no interest in pursuing.

This particular bank has a pretty robust current strategic plan. They asked that we review the current strategic plan to provide our thoughts and recommended changes, particularly in light of COVID-19. What was interesting about the initial discussion is that the bank was pretty open to changes to the strategic plan in order to address COVID-19. However, they were also very firm in what they were not open to. This particular bank was not a buyer or in an expansion mode. Instead, they have a market in a geographic footprint they like, and they are not willing to budge on those two particular issues.

We think this is a smart approach to strategic planning. We think it is beneficial to be just as strong in your beliefs as to what you are not as to what you are. This clearly defines the strategy and direction of the organization, and it allows those strategies to serve as guardrails for all other aspects of corporate decision making.

THE DIRECTORS' DILEMMA

Over the past month or so, we have been working with a community bank Board of Directors that has been faced with a difficult decision. The decision involves what the Board sees as two mutually exclusive alternatives. One alternative is to make a decision that is for the benefit of the holding company stockholders but is to the detriment of certain of the bank's corporate activities. The alternative decision would benefit the bank and its employees but would put the holding company shareholders in a less beneficial position than would otherwise be the case.

After much consideration and discussion, the Board ultimately made the decision that was to the benefit of the holding company shareholders. Frankly, we see this as the right decision, as we believe it complies with the directors' fiduciary duties. When faced with this set of alternative circumstances, our advice to the Board was that your fiduciary duties are much more clearly satisfied when you make a decision that benefits the shareholders to the detriment of the bank than you do when you make a decision that benefits a bank to the detriment of the shareholders.

This decision was not an easy decision for the Board, but we see it as the right one. Ultimately, the duty of a director is to make decisions that enhance shareholder value. This Board is to be commended for taking this advice to heart and making the touch decision.

KEEP SOME POWDER DRY

Over the last several weeks, we have had contact with several community bank clients who collectively are lamenting the age of their shareholder base. This is really not an uncommon situation since most of these banks are more than 50 years old and some more than 100. Many are on their second, third, and fourth generation of shareholders, and even those generational shareholders are getting older. Most of the boards realized that one of two things will happen when this shareholder base passes, particularly when the larger shareholders are involved. The holding company will either buy the stock back or the bank will be sold. Most of those who are staunch independents because of the service the bank provides to the community and the return to the shareholders will look for a way to buy that stock back.

When thinking about an aging shareholder base, the board really needs to look forward multiple years to determine whether the allocation of capital to buy those shares back should be, as a practical matter, reserved for now. In other words, instead of using up the capital now on something such as a small acquisition, it may be appropriate to keep some powder dry for that long-term need to repurchase shares.

CONCLUSION

We hope all of you are currently well and stay well. We, as you can tell from the Greetings line, are back on the "dusty trail." However, we are doing everything we can to protect ourselves and our families from the virus. We hope everyone had a great July 4th weekend and has the opportunity for some type of other than "stay at home" vacation this summer with family.

See you in two weeks.

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