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

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Dear Subscriber:

Greetings from Colorado, Nebraska, Iowa, Michigan, Georgia, Arkansas, Mississippi, and Wisconsin!

THE PPP LAMBORGHINI

Is it okay to use PPP funds received to purchase a Lamborghini? What if you title the Lamborghini in the company name? Apparently, the answer to that question is NO. It is not permissible to purchase a Lamborghini with PPP funds, particularly when you defrauded the government to obtain those PPP funds. A PPP borrower in Miami found out the answer to this question the hard way, as he was recently indicted for, among other things, defrauding the government and utilizing those funds to purchase a Lamborghini. Not the smartest crook.

EXEMPTION FROM VIOLATION OF SECTION 23A

As most *Musings* readers are aware, all community banks (even those whose friendly federal regulator is the FDIC or the OCC) are subject to the quantitative and qualitative restrictions of Section 23A and Regulation W of the Federal Reserve Act with respect to transactions involving affiliates of the bank. The OCC (the friendly federal regulator of national banks) recently released an Interpretive Letter that provided a requesting bank an exemption from a violation of Section 23A and Regulation W's restrictions. This is very interesting – not because it is unprecedented (Section 23A does permit exempting transactions if certain requirements are met, provided the other regulators do not object), but because it was actually utilized.

We have been in the community banking business for a long time and don't recall having seen the regulators give a "pass" on violation of any statute, but this is a very complex situation. This is primarily driven by some of the issues associated with the current pandemic. If anybody would like a copy of the OCC Interpretive Letter, please let us know.

THE DIFFICULTY OF CHANGE

Although change is a constant in all walks of life, particularly since the pandemic began, some community banks still have difficulty accepting change in the way things have been done for the past 50 years or so. We have found for some boards, (particularly those with young, aggressive Chief Executive Officers), that change can become almost a constant "irritant." Boards often wonder why things that worked so well for so long now need adjustment. Our general advice to these boards and CEOs is to embody the "change" in a comprehensive plan. That way the Board can approve all the changes at once, everybody buys in, and the implementation of the changes should be less painful. It is no longer an "irritant"; it is part of the plan. Piecemealing change throughout the organization, particularly when significant changes are needed, often becomes much more of a futile exercise – somewhat akin to poking a bear in the eye until he wakes up and finally does something about it. We do not recommend that.

ACQUISITION RISK MITIGATION STRATEGIES

We have previously reported in *Musings* that community bank merger and acquisition activity has increased fairly significantly over the past couple months. There are many banks that are currently on the hunt looking for acquisition opportunities. Over the past couple weeks we have had three different Indications of Interest approved, have submitted a couple more, and in the next couple weeks are scheduled to close an acquisition that came together pre-pandemic. This is a much different level of activity than was seen in April and the first half of May.

Although activity is picking back up, the current M&A environment is different than the environment pre-COVID-19. Prior to the pandemic, most of the acquisitions were very straightforward. The buyer purchased the target and paid either cash, stock, or a combination of both at closing. The buyer then took all of the risk associated with the target on a going-forward basis. The deals being discussed today are generally a little bit different, as they are involving risk mitigation strategies.

Buyers have a multitude of options at their disposal to mitigate risk in the target bank's assets and operations. These risk mitigation strategies include things like bad loan liftouts, earnouts, escrows, holdbacks, and the like. These various techniques are employed in order to achieve an appropriate risk allocation in the transaction. Buyers in today's environment are interested in doing deals, but their risk tolerance is lower than pre-pandemic, as would be expected.

If you are thinking of being a buyer in this environment, be sure that you keep these risk mitigation strategies in mind. If you are thinking of being a seller, do not be surprised if the buyer raises them and tries to work them into the transaction. As noted, this is all about allocation of risk, and whatever risk mitigation strategies are employed are completely dependent upon the negotiations between the buyer and seller.

NICE PROBLEM TO HAVE

We were recently visiting with a bank that was lamenting the fact that their loan growth was so strong that they were outstripping their capital. Their strategy was to only grow the balance sheet on the liability side (i.e., deposits and Federal Home Loan Bank advances) to the extent absolutely necessary to fund their loan portfolio. This particular bank has extremely strong loan demand in its market, and as a result of loan generation activities by its lending staff. Loan generation has resulted in significant growth of the balance sheet and significant growth of the bank's capital needs. Because profitability is somewhat of a lagging indicator, the internal capital generation (retained earnings) is not able to keep up with the balance sheet growth necessary to fund the loan portfolio, and thus the capital ratio is beginning to decline. The solution is to leverage the holding company at a low interest rate to generate capital for the bank. The bank can then leverage on an additional 10 to 1 basis, which will solve a good portion of the capital problem, as well as continuing to improve the profitability. A good choice.

EVOLUTION OF THE BANK'S LOAN COMMITTEES

Most community banks have an Officer Loan Committee and a Director Loan Committee. Beyond that, certain "bet the bank loans" are typically approved by the Board of Directors as a whole. It is important to understand that as the bank continues to grow and evolve, those loan committees need to grow and evolve as well. Their authority needs to be regularly reevaluated (i.e., How big a loan can the Officer Loan Committee approve? How big a loan does it take to get to the Director Loan Committee? What size loan should go to the whole Board?). Although we still have several community bank clients that are fairly large where the Board still approves any loan over $100,000, that is pretty much the exception. Make sure your loan limits for the Officer and Director Loan Committees evolve as the bank evolves and grows. Also, it is a best practice to have a written charter for those committees so everybody fully understands the duties and responsibilities of committee members, as well as the authority of the committee itself.

VIVA LA DIFFÉRENCE

We were recently visiting with a community bank that was discussing the difference in their markets. The bank has a number of markets that historically have been rural based. It also has a number of markets that are what could best be described as "metro" type markets. The healthy discussion involved recognizing the difference in those markets and the difference in the way customers should be approached and marketed to, as well as how the dollars should be spent. It was pretty clear that the rural customers expected significant personalized service, lack of fees, and deep long-term relationships. The commercial customers in the more metro markets were often chasing the best deal, did not mind paying the fees to get it, and would move for 25 basis points even if they valued the relationship. The point of the discussion was to acknowledge that the bank did in fact have separate markets that probably needed to be addressed separately to preserve and drive profitability in both markets. A good discussion.

DEFENSE AS A STRATEGIC PLAN

It is no surprise that the global pandemic has significantly altered the vast majority of community bank strategic plans. As we have previously noted in *Musings*, we are not aware of even one community bank whose strategic plan prior to 2020 in any way involved a strategy related to a global pandemic. The vast majority of discussions we have had with community bank clients lately related to strategic issues have involved discussions on appropriate adjustments to previously adopted strategies. Some community banks are moving towards what we describe as more offensive minded strategies, with the idea of taking advantage of the market disruption caused by the global pandemic. Most, however, are moving to what we consider a more defensive strategy.

It is important not to confuse a defensive strategy for complacency. Community bankers that are moving towards defensive strategies are not doing nothing. Instead, the defensive strategy is more along the lines of protecting against a major mistake. These community bankers are being very calculated in their decision-making in order to avoid a big mistake. The general comment we have heard over the past month or so is that community bankers recognize profitability is challenged, but the only thing worse than realizing decreased profitability in this environment is further exacerbating the losses by making a bad decision that stretches for yield and turns out to be wrong.

Many community bankers established strategic plans in 2019, where many of these banks enjoyed record profits. We believe many smart community bankers are realizing that high water mark will likely not be achieved again in 2020. That is unfortunate, but it is best to play the hand you are dealt. The one mistake we do recommend you work very hard to avoid is significantly increasing risk in order to reach for yield to try and cover the effects of COVID-19. We see many community bankers guarding against this by taking a defensive minded approach to strategic decision-making for the time being.

SUBORDINATED DEBENTURES

Over the past couple months, we have seen a number of community bank holding companies issue subordinated debentures. These are essentially ten-year, interest-only obligations at the holding company level. The subordinated debentures typically require bi-annual interest payments with a bullet principal payment at maturity. They are typically not allowed to be redeemed for the first five years of their issuance, in which they have a fixed interest rate, but they can be redeemed in the second five-year period, during which time there is an interest rate reset.

Why do subordinated debentures seem to be so hot in this environment? We think the reasons are three-fold. First, a number of banks are looking to increase capital in order to protect against the unknowns of the pandemic. Second, interest rates have come down in the last quarter, so the subordinated debentures have an interest rate today that is close to the interest rate on term bank stock loans that could be obtained pre-pandemic. Third, many investment bankers that were previously working on bank M&A transactions, which have slowed down, are now switching their efforts to other income producing activities for them, and subordinated debentures fit right at the top of the list.

We have always believed that leveraging the bank holding company is the first item the board should consider if the bank needs additional capital. We have always believed it best to first look at a bank stock loan, which can be drawn on incrementally as capital is needed and which typically has a little lower interest rate because it requires both principal and interest payments. However, given the decrease in interest rates, it may be worth at least considering a subordinated debt offering if the bank needs or has use for a significant amount of capital received all at one time. Some of the issuances we have seen are as low as 5% fixed for five years. We see that as pretty good on interest-only money.

THE IMPORTANCE OF THIS MOMENT

We are closely watching the economy, as we expect most *Musings* readers are as well. The U.S. Commerce Department recently released its initial estimates of the U.S. GDP in the second quarter of this year. Based on initial estimates, the second quarter had the steepest drop in more than 70 years. This pairs with, among other things, the Federal Reserve's recent comments that they expect to keep rates at basically zero until they have confidence the pandemic is past and the forthcoming reduction of the $600 supplemental per week unemployment benefits. All of this leaves us wondering whether the U.S. is on the edge of some type of economic precipice.

We do not know exactly where the next couple weeks or months will take us as a country, particularly as it relates to the economy. While we have no certainty as to the future, what we do know is that community banks have thus far weathered the storm pretty well. Most community bankers we are talking to have not seen significant asset quality deterioration as a result of the pandemic. Most community bankers have talked about some economic difficulties, but the overall comment seems to be that community bank asset quality has thus far remained strong. Whatever comes next, our sincere hope is that this trend for community banks continues!

CONCLUSION

It is right at the 1st of August. The kids will be going back to school soon (or will they?). There is still some time to enjoy a family vacation. We hope all of you get some good, fun family time. Stay safe and healthy.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- "Community Bank Capital Raising in Light of COVID-19" for ICBA – Greyson Tuck – August 11, 2020. Registration Link: Register - Capital Raising Webinar
- "Community Bank M&A in Light of Covid-19" for Graduate School of Banking at Colorado – Greyson Tuck - August 13, 2020. Registration Link: Register - M&A Webinar

