GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from "working remotely"!

PPP – PAYCHECK PROTECTION PROGRAM

By now we are certain that virtually all community banks are "knee deep" in Paycheck Protection Program loans. Although the PPP execution began with some confusion, lack of technology support, and other issues, it seems to be proceeding along fairly well at this stage. There were some significant issues that until yesterday had not been addressed, such as "Can we make PPP loans to our own directors?" When the initial guidance came out on PPP loans, it was abundantly clear that directors of a lender were not eligible. Fitting in the category of "making it up as we go along," the SBA recently put out additional guidance that indicated that a director of a community bank who owns a small business that is otherwise eligible can be an eligible borrower at his or her own bank for PPP loans, provided that the director is an outside director (i.e., not an officer) of the community bank and that neither the director nor his affiliates own or control more than 30% of the organization. Keep in mind, a PPP loan to a director also needs to follow Reg O.

One of the big benefits of the PPP program is not only keeping small businesses afloat, but also the fee income it is going to generate for the community bank lenders. We have visited with multiple clients who are looking at fees in the multi-million dollar range from PPP loans. The fee schedule basically provides an upfront fee to the lender of 5% for loans of less than $350,000; 3% for loans of between $350,000 and $2,000,000; and 1% for loans of more than $2,000,000. The fee alone is a pretty good return on what amounts to (hopefully) a risk-free asset. We have been answering numerous inquiries from our community bank clients across the nation on the PPP. We have been researching and finding answers to questions that nobody knew existed and that had not been addressed yet. If we can help you or your bank with any of these issues, please let us know.

FED CREDIT FACILITY

As most of you know, the Federal Reserve has created a credit facility where it will loan money to community banks at 35 basis points in order for those banks to fund their PPP loans. The loans from the Fed will be collateralized by the PPP loans, which are basically risk-free (assuming we do them right).

We have had discussions with numerous banks over the last two weeks about funding the PPP loans. Our typical advice with a community bank that wants to grow its loan portfolio is to start with a "reallocation of assets" strategy where cash and securities (depending on the rate) get reallocated into loans. After that, additional funding sources would be necessary. In a typical loan growth strategy (which this is not), additional funding sources, if they are from deposits or the Federal Home Loan Bank, will result in growth of the balance sheet, which for capital leverage ratio purposes will require additional capital.

Recently, the friendly federal regulators (OCC, Federal Reserve, and FDIC) indicated that because the PPP loans booked and pledged to the Fed will basically be risk-free, they will have a zero risk-weighting for the risk-based capital ratio and will be excluded from consolidated assets for purposes of the leverage ratio. In other words, if the community bank wants to balloon up its balance sheet significantly, it will not adversely impact the capital ratio, provided it does so through the Fed PPP Facility. For example, if a $200 million community bank with 10% capital (i.e., $20 million) wants to make $100 million of PPP loans and does so through funding from the Federal Reserve Credit Facility, then its leverage ratio will remain at 10% because the loans booked and pledged to the Fed will be excluded from consolidated assets when calculating the leverage ratio and have a zero risk-weighting.

This may be one of those cases where "the government is here to help you." Between that and the fees off the loans, it should put most banks in a pretty good position.

ONE PPP ISSUE TO CONSIDER

We trust that most community bankers and community bank directors have said the letters "PPP" more times over the past two weeks than you have taken breaths. Hands down it is the topic du jour of community banking.

We have had many discussions with bankers all across the country related to PPP. You will not be surprised that the prevailing belief among borrowers is that this is essentially a $350 billion benefit for small business. That is mostly true, with the very important caveat that PPP loan applicants must certify that "Current economic uncertainty makes this loan request necessary to support the ongoing operations of the applicant."

The regulatory guidance generally supports the idea that lenders are entitled to rely upon an applicant's certifications in the PPP application, including the certification as to need. However, we see a potential problem in the event the lender either knows or should have known that the certification is not entirely accurate. In other words, what is the potential lender's liability, if any, if a borrower requests a $75,000 loan while sitting on $150,000 in cash deposits at the bank?

We anticipate that at some point in the future there will be what is essentially an Inspector General assigned to review the program applications and operations for abuse (similar to the TARP Inspector General). Our concern is related to potential lender liability when abuse is identified and both the Inspector General and the borrower argue that the bank knew or should have known that the certification of the applicant was not entirely truthful. We certainly hope this does not come to pass, but we think, notwithstanding the right of the bank to rely on representations of the borrower, that the risk is real.

GOLDEN HANDCUFFS

As most Musings readers know, the term "golden handcuffs" relates to the ability of the community bank to retain its key senior management team by, in part, providing benefits that are forfeited if the individual leaves the community bank's employment. Although we have not seen many voluntary employment changes in the last month or so, for obvious reasons, we are still getting inquiries from a number of our clients as to the best way to set golden handcuffs for senior executives. Our general advice is that a number of things come to mind, including supplement retirement plans funded by BOLI. These plans generally provide that the employee has to work to a certain age to get the benefit. There also is restricted stock with the restrictions to be set by the Board of Directors such as there is a forfeiture if there is a departure, at least within some certain period of time. Also, stock options, which hopefully eventually will be significantly in the money, would be forfeited prior to a vesting. There are also a number of other golden handcuffs that could be placed on the senior executive team. These are really reserved for those key executives that the community bank simply would be in a world of hurt if it lost. Often, these benefits are combined with an employment contract containing a non-compete and the like. Many of our clients are looking post-pandemic and are trying to make sure that they keep the key management team currently in place, in place.

GEOGRAPHIC EXPANSION

With the pandemic continuing, one would think that community bank geographic expansion has come to a screeching halt. To some extent, that is true. The forward-thinking boards, however, are looking again beyond the pandemic to determine what geographic expansion makes sense for their bank. Does an acquisition of another bank make sense? Does an acquisition of bank branches or credit union locations make sense? Should the bank expand de novo into a new market? Generally, whether it is an acquisition or an expansion of a de novo into a new market, the key issue is whether the bank can obtain the franchise player in that market. Going into a new market, particularly one that is not adjacent to the bank or where the community bank is not known, without the franchise player is a daunting task. Even with a franchise player, there are issues that need to be addressed.

We recommend that the board begin thinking post-pandemic about geographic expansion that makes sense. Hopefully, this recovery will be more of a V curve than a slow slope, so post-pandemic we will need to provide some strategic thinking as it relates to geographic expansion.

WHAT IS YOUR RISK TOLERANCE?

If your board has not yet done so, we suggest your next board meeting include an appropriate amount of discussion on organizational risk tolerance in light of the pandemic. We think this is important for a number of reasons.

First, the board identifying the organization's risk tolerance essentially sets the guardrails for management in terms of responding to the pandemic. For example, the discussion will clearly identify for management the board's views on loan-to-value exceptions, debt service coverage ratio exceptions, and the like. This will be important as management considers responses to what are certainly going to be numerous requests for credit accommodations, new credit extensions, and similar customer requests.

Second, we think a board discussion on organizational risk tolerance is important from a regulatory perspective. Your next examination will certainly include a review on how the board responded to the pandemic. The regulators will expect the board to have discussed organizational risk tolerance. We recommend this discussion be noted in the minutes of the meeting.

From a practical perspective, we think the board really has the opportunity to go one of a number of ways. It could reaffirm its existing organizational risk tolerance, which is encompassed in all of the various bank policies. The board could also either tighten or increase organizational risk tolerance, as determined appropriate. Obviously, increasing risk tolerance will allow the bank to go after more opportunities but will increase risk and likely losses down the road. On the other hand, tightening risk standards may make the bank a little bit safer but will result in missed opportunities to assist customers.

Overall, we believe the important thing is that the board give this issue consideration and identify its level of risk tolerance in light of this significant event.

SPEAKING OF LOAN MODIFICATIONS…

If they have not already begun at your bank, we expect the next two to three months will bring a significant number of requests for borrower accommodations. It is likely that the majority of your borrowers will ask for some type of relief, whether it be deferral of payments, forgoing principal for interest only for a period of time, or something similar. Certainly, the regulators expect a significant number of these requests given the recent regulatory guidance regarding the same.

As it relates to these borrower requests, we encourage you to keep fair lending issues in mind. Frankly, we see some compliance and regulatory risk in these loan modifications, notwithstanding the regulators' previous guidance. Our concern does not relate so much as to whether or not they are treated as TDRs. Instead, we have concern related to fair lending issues. Our primary concern is the regulators taking some type of stance that a fair lending violation occurred when two similarly situated borrowers receive materially different accommodations. Our concern is similar to deviations from standard rate sheets.

As we continue to move forward in addressing the fallout from the pandemic, keep these fair lending issues in mind. We recommend you establish some type of standard forbearance and loan modification agreement and try to limit deviations to the extent possible. Please let us know if you would like to discuss any issues specifically or would like assistance in drafting a loan modification and forbearance agreement.

STRATEGIC PLANNING UPDATES

We are about a month or so into life with COVID-19 as a significant disruptor. We are beginning to receive calls from bankers that are wanting to schedule strategic planning updates. These are not full blown strategic planning sessions. Instead, these are requests that we facilitate board and officer group discussions on how COVID-19 affects the organization's existing strategic plan. In other words, these are banks that recognize we are not out of the woods by any means, but they are being forwarding thinking in how the last month or so is affecting and requiring change to their existing strategic plan.

If you are not thinking about it already, we recommend you give some thought to a strategic planning update. We think it will be beneficial for the board and officer group to spend an hour or two with the current strategic plan to discuss appropriate changes. In football terms, these are essentially viewed as halftime adjustments. In community banking terms, it is dedicating discussion time to how this significant event changes the bank's previously adopted strategies.

PPP – THE LAST WORD (FOR THIS MUSINGS ANYWAY) – THE ESSENCE OF COMMUNITY BANKING

Many community bankers have been working almost around the clock to assist their customers in obtaining PPP funds. The stress has been high, the frustration constant, and the workload heavy. However, the efforts are completely worth it. This is evidenced by an email we recently received from a client related to a PPP loan issue that closed with a statement that the majority of the bank's customers cry when they get the loan funds because at least they have some hope for a couple months. To us, this statement absolutely sums up the essence of community banking!

We know over the past couple weeks the tremendous amount of effort that has been put forth by you and your employees on behalf of, and for the benefit of, your customers. It is no mystery to you that your work is vital to your communities. We are all in this together, and community banks continue to lead the way in customer service. Keep heart, as your efforts are not in vain!

CONCLUSION

Although we know most communities are "in lockdown" in virtually every state in the country, we are continuing to look forward to visits with many community banks over the summer and fall for already scheduled meetings. Although we have had many meetings over the last couple weeks through electronic means, we still believe that face-to-face is more effective and look forward to resuming visiting you at the bank.

In the meantime, stay safe, enjoy the family, and make the best of the lockdown.

See you in two weeks.

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