GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from "working remotely"!

PERMISSION OR FORGIVENESS?

It is still too early to fully understand the impact of the COVID-19 pandemic on asset quality for community banks. As we have indicated in prior *Musings*, we firmly believe there will be some community banks that will experience little, if any, impact on their asset quality from COVID-19. For some, those primarily dealing with essential workers and essential businesses, asset quality may continue to remain strong or even improve. Others not so much. Although the friendly federal regulators are "mouthing" all the right words when it comes to forbearance and the like as a result of banks' actions during the pandemic, if history is any predictor of the future, then it is likely at the next exam cycle the friendly federal regulators will be griping about the community banks not having enough capital or inadequate reserves or something similar. The tier 1 leverage ratio that we hear the friendly federal regulators pounding the table most about (once they get off expecting your community bank to be at your peer level, which is generally way more than you should be) is somewhere in the 9% to 10% range. So what should you do if you are below 9%, for example? Should you leverage your holding company to increase the leverage ratio above 9% just to satisfy the regulators? Should you wait until the next exam and see how badly they fuss at you about the capital ratio? In other words, should you be proactive with respect to increasing the capital before they gripe about it, or reactive after they gripe about it?

Our recommendation depends upon the strength of the community bank's asset quality. If the bank's asset quality continues to remain strong, then certainly operating at the low end or slightly below the low end of the capital ratio expectation is acceptable. If asset quality is soft, then increasing the ratio to provide some buffer will certainly relieve some of the anxiety of having to deal with the regulators. If your community bank holding company is borrowing money (and paying interest on it) to create that capital buffer at the bank, how much is that "buffer" worth in actual expense to the consolidated organization just to keep your friendly federal regulators from griping at you? That is a question that every board should ask itself. If you need help working through these issues, let us know.

THE FUTURE OF FINTECHS

During the five or so years prior to the pandemic, much discussion around community banking involved the significant threat posed by fintechs. Almost without fail, any discussion regarding the future of the community banking industry, whether it be in a strategic planning session, conference, or cocktail party, involved questions as to whether fintechs, primarily online lenders, may be the death of the community banking industry. It appears the pandemic has laid bare the flaws in arguing that fintechs and online lenders are the death of community banking.

We recently read with interest an article in the *American Banker* that summarizes the state of various high profile online lenders. These include fintech competitors such as LendingClub, OnDeck, Square, and the like. In summary, the article is a pretty scathing exposé on the status of these businesses. Their loan demand has been decimated, and their asset quality significantly diminished. What were once Wall Street and venture capital darlings appear now to be on the ropes with significant questions about their ongoing viability.

It was Warren Buffet who once famously said, "only when the tide goes out do you discover who has been swimming naked." This certainly appears to be the situation in which we find ourselves. Based on the recent action of fintechs, we do not anticipate they will be the death of community banking. Instead, we think the opposite may be true, where community banks look for acquisition opportunities to buy these fintechs and their related technology at significantly discounted valuations. Please let us know if you would like a copy of the *American Banker* article.

TELECOMMUTING POLICIES

There has been much talk lately about the "new normal" that will become an everyday part of life going forward. Part of the discussion relative to this new normal is the idea of a significantly more mobile workforce. It is generally anticipated that all companies, including community banks, will see an increase in the number of employees working from home. Based on this expectation, we have had a couple community banks ask whether we recommend the adoption and implementation of a telecommuting policy. Our response is yes.

As the name implies, a telecommuting policy is basically a document that governs remote working operations. Some might be temporary setups, while others are hired with an expectation of working remotely full time. Whatever the case, we do recommend that the bank set forth in writing the expectations and guidelines for remote working.

Please let us know if you would like assistance in drafting a telecommuting policy for your bank.

REMOTE WORKING AS TALENT ATTRACTION

Speaking of telecommuting, over the past couple weeks we have had discussions with a couple different community banks, primarily located in more rural areas, that see telecommuting as a new talent attraction tool. COVID-19 has convinced these community banks that it is not necessary to have every employee be physically present in the bank branch day in and day out in order to effectively perform their respective jobs. In light of this revelation, these banks are thinking about ways to recruit talent by offering remote working as a permanent setup. The idea is to use the opportunity to work at home as a way to attract primarily younger workers that are more interested in working in urban areas rather than rural areas, which is where these banks predominantly have branch locations.

We classify this line of thinking for community banks as "forward thinking." We anticipate there will be a number of companies that migrate toward an increasingly remote workforce. Community banks that are willing to put in the effort to figure out how to make this work as a talent attraction tool will be better situated for attracting and retaining talent than those that continue to take the position that all bank employees must be physically present in the bank branch to perform their jobs.

ESOPs AND KSOPs

Over the last several weeks we have received multiple inquiries from clients regarding the establishment of an ESOP or KSOP for their community bank. As we have often noted in *Musings*, an ESOP or a KSOP is a great way to incent employees, provide liquidity for shareholders, assist with the transition of ownership, and provide a wealth-building mechanism for all employees (and the senior management group in particular).

Most ESOPs and KSOPs these days are formed with a specific purpose in mind. Often, the purpose is to provide liquidity for a shareholder's or shareholders' estate that needs it. This use of an ESOP or KSOP typically involves the ESOP or KSOP borrowing money to purchase the stock. As we have often noted in *Musings*, an ESOP or KSOP works extremely well in an S Corporation. An ESOP or KSOP also works very well in a C Corporation because the debt is serviced with compensation expense, and both principal and interest, as a practical matter, are tax-deductible. In an S Corporation, the additional benefit of the ESOP or KSOP receiving the tax distribution as well as a dividend equivalent distribution creates a massive cash accumulation in the KSOP or ESOP since it is a tax-exempt entity and gets to keep the "tax distribution," unlike the human being shareholders who have to pass that on to the federal and/or state governments. ESOPs and KSOPs are a wonderful tool. If anyone would like any further information or to discuss the ESOP/KSOP opportunity for your community bank, let us know.

PPP LOAN FORGIVENESS

A little bit more than a week ago, the SBA released their official guidance on PPP loan forgiveness. It was not met with cheers, to say the least. Compared to the borrower's application form, the loan forgiveness form is long, complicated, and cumbersome. (We have actually speculated that the SBA acquired a disgruntled IRS employee to draft the form.) It also even furthers our concerns relative to lender liability related to PPP loans. We do not mean to sound like a broken record, but we continue to believe that PPP loan originators have an appreciable amount of potential liability in the program, regardless of what the SBA and Treasury may be publicly saying.

Virtually all of the banking advocacy groups are working to improve the PPP program, including the loan forgiveness process. They are advocating for more flexibility in the use of funds and a more "user-friendly" loan forgiveness application form. If you have not done so already, we urge you to consider in joining this grassroots advocacy effort. We certainly see it as important.

GERRISH SMITH TUCK TEAM MEMBERS

As many *Musings* readers are aware, we formed our consulting and law firms 32 years ago. We have had many long-standing team members, both professionals and staff, with us over a good portion of that time period. Two of those team members, Carolyn Martin (Philip Smith's Administrative Assistant) and Jackie McCaskill (our firm's long time Office Manager) - both of whom apparently indicate they qualify for Medicare now - have decided to retire effective today.

We are proud to have worked with Carolyn and Jackie over the last almost 20 years. They have been a wonderful part of the Gerrish Smith Tuck team. We will miss them greatly. We will also be adding Alisha Marr as an additional Paralegal/Administrative Assistant and have promoted Associate Jason McCuistion into the Chief Operating Officer role.

Our plan is to continue to provide the same excellent quality of service and quality of work that our community bank clients have come to expect.

CONCLUSION

We hope all of you had a great Memorial Day weekend and a nice post-Memorial Day "short week." Although our firm has been fully operational remotely, starting June 1st our offices in Memphis will be fully operational on site. We look forward to seeing many of you in our Memphis office, in person on the road, or by Zoom in the near term.

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

