GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from North Carolina, South Carolina, Virginia, Delaware, New York, Vermont, Pennsylvania, and Ohio!

THE "NEW" CONSUMER COMPLIANCE ISSUE

We recently received a telephone call from a community banker who was frustrated with his bank's recent compliance examination. During the examination, the onsite examiners cited the bank for an Unfair, Deceptive, or Abusive Acts or Practices (UDAAP) violation . The examiners essentially said the bank was engaging in an abusive practice as it relates to the bank's overdraft program. The general gist of the examiner's complaint is that the account agreement did not support the manner in which the bank was assessing overdraft charges.

This banker was particularly frustrated because this was the first time this issue had ever been raised by the examiners notwithstanding the fact that the bank had been through a number of previous examinations where the deposit account agreement and law were exactly the same. In other words, the examination team created a "new" consumer compliance violation based on a seasoned account agreement and set of laws and regulations that had been through multiple prior examinations.

We agreed that it is particularly frustrating when the examiners have for years determined something to be acceptable and then one day completely change course and determine the same set of circumstances to be wrong. It is tough to hit a moving target!

ECIP CONCERNS

If you are not familiar, over the months of May and June the United States Treasury is going to inject about $9 billion into community banks that are Community Development Financial Institutions and credit unions through the Emergency Capital Investment Program. The program is essentially TARP 2.0 and provides for capital that has a low cost of about 2%, which can be lowered down to 0% with the achievement of certain types of loan growth. For C corporations, the investment comes in the form of preferred stock. For S corporations it comes in the form of debt. Both the preferred stock and debt have some features that are similar to TARP, including the right for Treasury to take certain corporate actions if the holding company misses a certain number of dividend or interest rate payments.

We are working with a number of community banks that are taking ECIP funds. We are all for access to cheap capital, and taking the ECIP funds makes sense in a number of circumstances. That said, we are not completely without reservations as it relates to the program. We think it is ripe for potential problems, and we are encouraging ECIP recipients to think through those issues.

Our main concern with the ECIP program is the amount of capital that many community banks are taking when compared to their current capital levels. Most community banks are going to at least double their capital overnight. Our concern is that a significant injection of capital will drive these community banks to believe that they must grow into their capital almost as quickly as it came into the bank. Past experience has taught us that doubling the size of a community bank in a short amount of time is often a recipe ripe for disaster. We have seen numerous times where community banks have sacrificed disciplined banking principles for the sake of asset growth.

If your community bank is taking ECIP funds, please keep this issue in mind. It is very likely your Tier 1 Leverage Ratio is going to double (or more) overnight. If that happens, be sure that disciplined banking principles are absolutely front and center as you look to achieve growth to normalize the Tier 1 Leverage Ratio. We do not have to look too far into the past to identify similar circumstances where supercharged growth did not turn out so well for hundreds of banks across the country.

CONSUMER FINANCIAL PROTECTION BUREAU

The Consumer Financial Protection Bureau is under attack. We certainly do not mind this as a matter of public policy or principle, but we do find it unusual as to who is leading the charge. In this case, the American Bankers Association, which represents banks of all sizes (not just community banks), is leading the charge against the current Director of the CFPB, Mr. Chopra. The ABA's position is embodied in a recent *American Banker* daily editorial authored by the ABA Chief Executive Officer Rob Nichols. Mr. Nichols takes issue with the CFPB's ongoing public relations campaign regarding "demonization of financial services." The editorial initially focuses on issues associated with the CFPB's term "junk fees" of financial institutions, among other matters. What we find particularly unusual is that a national trade association would attack a sitting Director of a federal bank regulatory agency, although it certainly is not unprecedented. In the Biden Administration's attempt to appoint a permanent Comptroller of the Currency, the Independent Community Bankers of America went for the jugular to make sure that Ms. Omarova was not confirmed. Their advocacy efforts resulted in withdrawal of the nomination. We commend both national trade associations for sticking up for their constituents and not being afraid to take some heat when the government is either running over the financial services industry or has the potential to do so.

REGULATORY APPLICATIONS

We are in the process of dealing with all three of the federal regulators and several different state regulators on various applications for approval of mergers between community banks and their holding companies and various targets. Although each of the regulators takes a little bit different slant since they each have separate responsibilities, the one common theme running through all the regulatory application processes is simply it "takes longer." Prior to the change in administration, the regulatory approval process was fairly quick and seamless. With the current administration, particularly with Congress demanding a harder look at bank acquisition transactions (primarily the big ones), the regulators are being extra cautious. That shouldn't discourage any of you from pursuing strategic opportunities to make acquisitions. It is simply one of the issues that needs to be factored into any community bank acquisition of another bank or any other entity that needs regulatory approval.

ESOP OR KSOP PURCHASES

We have had a number of discussions with clients over the last several months about utilizing their ESOP or KSOP to purchase shares in the marketplace or from a particular individual shareholder. As we have often indicated in *Musings*, an ESOP or a KSOP can not only serve as a significant employee benefit (particularly in a Subchapter S), but it can also serve as a mechanism to create share liquidity for existing holding company shareholders or even raise capital through leverage of the ESOP or KSOP.

One issue there has been significant confusion on of late is the price at which the ESOP can purchase shares. The general rule is the ESOP cannot purchase shares above appraised value. Most *Musings* readers are not public SEC-reporting companies, so if your community bank/holding company has an ESOP or KSOP, you are generally required to get an annual valuation. If you are a public SEC-reporting company listed on NASDAQ (with sufficient trading), for example, that would serve as a market value and no external valuation would be required. As noted, the general rule is the ESOP cannot purchase at above the valuation price. The confusion comes in as to whether the ESOP can purchase at below that price. The answer, of course, is yes. We have had a number of clients where the valuation price for their community bank may be 120% of book, but there are willing sellers to the holding company or the ESOP at book value. There is no problem at all with the ESOP purchasing at that price point. The general rule for the ESOP is it can purchase shares up to and including the fair market valuation price, just not above it.

DEBT CAPITAL

Over the past several years, we have assisted multiple community banks in raising debt capital. As we have often touted in *Musings*, the government is here to help those community bank organizations whose consolidated assets are less than $3 billion (i.e., the Small Bank Holding Company Policy Statement). Most of the debt issuances over the last several years have been subordinated debt (as pushed by the investment bankers). We always refer to this as the "new" trust preferred. It is, for the most part, a 10 year interest-only obligation with five years fixed. There are still a fair number of subordinated debt issuances occurring, notwithstanding the rising interest rates. Over the last few months, most debt issuances have been priced in the 3.75% to

4.25% range, and we anticipate as the Fed increases interest rates that the sub-debt rates will increase commensurately.

We have no objection to any community banks issuing sub-debt. We are happy to help them do that. As we have often indicated in *Musings*, the subordinated part of it and the fact it counts as tier 2 capital means nothing for a bank under $3 billion since the organization is not tested for capital adequacy on a consolidated basis. The more important issue is whether there is something to do with the capital the sub-debt would generate. If your $300 million bank sells $10 million worth of subordinated debt and generates $10 million in cash at the holding company, is there an opportunity to deploy that cash? If you contribute it to the bank as capital, it will raise the capital ratio a couple hundred basis points. You could also use it to redeem shares, acquire another institution, or something similar. Just make sure you have a good strategic reason to generate the cash resulting from the subordinated debt; otherwise, you will be paying interest on a debt obligation that you don't need.

CANNABIS BANKING

Over the past several weeks, we have had the opportunity to spend time with a couple different community banks that are engaged in cannabis banking. Each of these community banks is located in a state where medical marijuana is permissible. One of the community banks is located in a state where recreational marijuana is also legal. The discussions with each of these community banks were interesting because they focused on the business opportunities available in banking cannabis-related businesses rather than the potential regulatory pitfalls.

When states began to legalize marijuana, many community banks were questioning whether there was any way those customers could be banked in a way that preserved the bank's good graces with the regulators. Now that a number of years have passed, community banks have figured out the answer to that question is yes. Those community banks that are banking cannabis-related businesses have generally reported the regulators are receptive to their activities in this area. This has caused community banks to shift their focus from compliance concerns to business opportunities.

There are numerous opportunities to make money in banking cannabis-related businesses. The most prevalent are fees on deposit accounts, which seem to generally run about $2,000 to $4,000 per account per month, and loan interest income. Given this shift in fundamental focus, we anticipate the number of community banks that are willing to bank cannabis-related businesses is only going to get higher.

(And we recognize that if Congress passes a law decriminalizing marijuana all of these regulatory related concerns will completely go up in smoke.)

ECONOMIC CONCERNS

As most *Musings* readers know, our firm is a community bank legal and consulting firm. We are all trained as attorneys, but also have some business acumen through an MBA, Masters in Tax, Masters in Accounting, former regulatory experience, and the like. We are not strictly economists (although some of us have an economic background). Notwithstanding all that, however, we do view understanding the economy and where it might be going as one of the fundamental obligations we owe to our clients. If we did not, we would not be well-positioned to provide advice and counsel.

Frankly, the economic outlook and potential for further economic headwinds over the next 12 to 24 or so months gives us pause for concern. Inflation that is at 40-year highs, a tightening monetary policy through increased interest rates, continued supply chain concerns that are only heightened by China's zero Covid policy lockdowns, a war in Ukraine, significant volatility in the stock markets, and other similar matters present difficulties that should be appreciated. Thus far, these issues seem to be effecting community banks primarily in the market value of the securities portfolio and related unrealized losses. However, we do not anticipate the damage will be limited to this one aspect of the bank. We anticipate the reverberations from these various issues will stretch wider.

Please do not hear what we are not saying. We are not espousing an undeniable forthcoming recession, although we do recognize one is possible. What we really are saying is we think tougher times for the community banking industry are on the horizon, notwithstanding the pristine asset quality and good earnings currently. What that means is that community banks need to prepare. As interest rates increase, we anticipate there will be loan renewals that do not cash flow at higher rates, higher provision expenses, weaker loan demand, and similar challenges. As community banks, let's look forward and be prepared.

CONCLUSION

It appears "spring has now sprung" in most parts of the country. This is notwithstanding our experience with recent blizzards, delayed flights, and the like. We hope soon the entire country will be engulfed with mild temperatures and bright sunshine. We look forward to seeing many of you in our travels around the country.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations

- May 5, 2022 – Graduate School of Banking-Wisconsin Webinar; "Strategies to Remain Independent in a Consolidating Environment" (Greyson E. Tuck, Presenter) Registration: Strategies to Remain Independent in a Consolidating Environment
- May 12, 2022 – Graduate School of Banking-Wisconsin Webinar; "Financial Analysis of Bank M&A Transactions" (Greyson E. Tuck, Presenter) Registration: Financial Analysis of Bank M&A Transactions
- May 18-20, 2022 – Louisiana Bankers Association 122nd Annual Convention and Exposition; May 18th - "Practical Advice for Community Bank Directors" (Greyson E. Tuck, Presenter) Registration: Louisiana Bankers Association Annual Convention
- May 23-26, 2022 – Abrigo ThinkBIG Conference; May 25th - "Dusting Off the Crystal Ball: Banking in 2042" (Greyson E. Tuck, Presenter) Registration: THINKBIG
- June 27-28, 2022 – Independent Community Bankers of America Community Bank Mergers & Acquisitions Workshop (In Person) (Philip K. Smith and Greyson E. Tuck, Presenters) Registration: ICBA M&A Workshop