FENIMORE KAY HARRISON FORD

CLIENT ALERT

COMMUNITY BANKING AMID COVID-19 CONCERNS

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As community banks across the country grapple with market and economic dynamics heavily influenced by COVID-19, or the Coronavirus, separating data from speculation can be a difficult challenge. While we are hopeful that adverse conditions will be short-lived, we believe planning for a wide range of outcomes is the best way to manage risk and prepare to seize opportunities. As we have discussed the potential impacts of the virus with our clients, we have developed the view that community banks can best plan for the near future by relying on two of their greatest strengths: their ability to implement change quickly and their intimate knowledge of the dynamics of the markets they serve.

By relying on these strengths and understanding that success is inseparable from consumer and business activity in their markets (even if that activity is irrational at times), community banks can navigate the current challenging circumstances and even find opportunities in this turbulent environment. Below are the key points we have gleaned from our work with community banks in recent weeks and from experience with previous market challenges, grouped by the various roles that banks play in their markets.

Banks as Employers

There are many great resources already available from government agencies, human resources consultants, and labor attorneys regarding best practices and compliance in dealing with various employment-related issues. Those include the following.

- For practical guidance, banks can consult the playbook published by the correspondent banking division of CenterState Bank.
- See the Americans with Disabilities Act pandemic preparedness guidance and the OSHA pandemic factsheet are helpful resources.
- An outbreak could also trigger policies around the Fair Labor Standards Act and the Family Medical Leave Act. The Society for Human Resources Management, or SHRM, has a Coronavirus FAQ page that can help.

At a high level, we believe good communication with employees to be the key. Most of our clients have done a good job of starting that process. Going forward, we suggest that banks engage in continued, constructive dialogue with bank employees regarding the objective facts. Banks cannot control the anxiety that employees may have as a result of the virus, but banks can reassure their employees of management's constant focus on their well-being and diligent research of the facts surrounding the virus. By doing so, we are hopeful that banks can help their employees remain engaged and focused on productivity while at work. Likewise, if the spread of the virus leads to temporary branch closures or other more impactful measures, employees should be armed with a specific, actionable plan. Good corporate communications now can lay the groundwork to implementing this action plan efficiently and effectively.

Banks as Lenders

Banks must also focus on changes in credit risks resulting from changing consumer behaviors focused on preventing spread of the virus and the related impact on national and global economies. We believe banks should take the following actions in the credit area in response to virus concerns.

- Loan officers should consider the risks to the businesses that are in their portfolio. Loan officers should also communicate with those borrowers to understand their action plans and generally ensure that the borrower understands and is prepared for the range of outcomes related to virus concerns.
- Loan officers should ensure timely delivery of required financial statements and, if applicable, compliance certificates from borrowers. The bank should have a general view of how it will treat covenant defaults, be it with a limited waiver or a forbearance in exchange for risk mitigation offered by the borrower.
- Banks should understand the impact of rate changes on their borrowers. While generally borrowing costs should improve borrower financial health, some borrowers are impacted by rate volatility more than others.

Banks should view covenant defaults or requests for lower rates (even those caused by competitive pressures) as opportunities to reassess and rebalance risk in the loan portfolio. Although lenders will generally want to keep their customers and avoid negotiating terms, banks should evaluate their willingness to add provisions around pandemics to loan agreements and should allow higher-risk customers to leave if another bank is willing to refinance them to a lower rate. As a smart banker once told us, there are worse things than being paid off. We think that's especially true under current circumstances, and the competitive pressure caused by plunging rates should not lead to a reflexive race to the bottom.

Banks as Regulated Entities

Of course, a formidable constituency for ensuring a sound plan to address virus concerns is the regulatory agencies. As with employees, communication and a sound, well-reasoned plan are keys to success from a regulatory standpoint. Banks should prepare to engage with regulators by taking the following actions.

- Banks should read and understand the recently-released Interagency Guidance on Pandemic Planning.
- Banks should understand where high-risk segments of the portfolio lie. Just as many banks have managed concerns over commercial real estate in the past, exposure in the following areas should be evaluated and stress-tested to the extent feasible.

    - Hospitality
    - Transportation
    - Tourism
    - Energy, particularly oil and gas
    - Communities with concentrations of employees in any/all of the above industries

- Consistent with the analysis above, banks should develop a model that shows the impact on capital from losses in high-risk buckets.
- Banks should develop a view with regard to any potential long-term impacts on the commercial real estate markets and incorporate that view into their underwriting.
- Banks should have and share their internal response plan for confirmed cases of the virus among bank employees or bank customers.
- Banks should test and share their plan to ensure critical operational areas will remain functional, even in the face of high levels of employee absences or in the absence of key employees.
- Banks should also update their capital plans and budgets to reflect the recent and any future rate cuts.

We are hopeful that regulators will serve as an open-minded resource for banks in addressing the challenges of the day. However, our experience is that regulators tend to dictate their views to banks if bankers have not done their own thinking prior to a supervisory call or visit. If a bank is comfortable that it has taken reasonable steps to prepare, management should feel comfortable reaching out to regulators to share its efforts and to seek further insight.

Banks as Managers of Liquidity and Interest Rate Risk

Most of our clients have been busy addressing interest rate risk as a result of the recent rate cut by the Federal Reserve. However, more work in this area may be necessary. Below are some ideas for further analysis.

- As zero rate and negative rate environments seem less speculative, banks should update ALCO policies to ensure they are properly aligned with what we hope will be a short-lived depression of rates.
- Banks should stress test liquidity under various adverse scenarios.
- In addition to managing deposit rates carefully, banks should reconsider the position of all liability funding in the organization. Those receiving attractive rates should be truly prized customers. If funding is being provided from wholesale sources, banks should analyze whether the source is the most affordable option under current circumstances.

Banks as Managers of Capital

The debt markets are intriguing for banks at this time. At present, it appears that liquidity remains strong among purchasers, and rates are incredibly low. At the same time, money is flowing out of equity securities at alarming rates. As a result, banks should consider the following actions.

- Consider accumulating capital, either to deal with challenges or to address potential opportunities, particularly as it relates to M&A opportunities.
- Consider accessing the debt capital markets, particularly the issuance of subordinated debt.
- Consider refinancing holding company debt at lower rates.
- If the future is especially concerning, consider drawing on holding company lines to hoard liquidity.
- Consider withholding dividends and distributions, particularly for S-corporations that have been making significant distributions. Even if the virus concerns are short-lived, they may provide an opportunity to reset dividend expectations for circumstances in which capital retention has not been strong enough to support growth.

Perhaps the most interesting aspect of capital management in the current market is share buybacks. On March 9, 2020, many of our publicly-traded clients saw their share prices drop more than 10%. While this sudden drop may create a great opportunity to repurchase shares at an attractive price, banks should also refresh their capital plans in light of current circumstances before proceeding.

Within the topic of share buybacks is the establishment of Rule 10b5-1 trading plans. In short, these plans allow a third-party broker to repurchase shares on behalf of the company pursuant to a pre-established formula established by the company. The advantage of doing so is that shares can continue to be repurchased even if the bank is in a black-out period around quarterly earnings or a specific event or if the bank is otherwise in possession of material nonpublic information. However, publicly traded banks seeking to establish these plans should be mindful of the following best practices, particularly the requirement that they be entered into in good faith.

- Plans should generally have a duration of approximately 12 months. Plans established for a period as short as three months tend to present more risk that they would be deemed to have been established in an effort to evade securities laws.
- Plans should be built on long-term views of share value. In general, plans should not become active until 30 days have passed since their approval. This guideline means that it is more difficult to establish a plan simply to capture the benefit of current volatility.
- On the other hand, for banks that have existing plans, the good faith requirement does not mean that pricing parameters can never be adjusted. The realities of the current market could not have been anticipated. So long as a bank is not in possession of material nonpublic information, adjusting the pricing formula does not necessarily indicate a lack of good faith in establishing the plan, though it could bring additional scrutiny.

Whether or not share buybacks are completed within a trading plan, banks should consider whether any unique risks related to the virus would cause them to be in possession of material nonpublic information. If so, securities transactions should be avoided by the entity as well as its insiders.

Finally, most banks are not considering equity raises under the current circumstances. However, for most privately-held institutions, raising capital takes time. As a result, banks should continue to consider their longer-term needs for equity capital funding and take appropriate actions to prepare. Markets can change quickly.

Banks as M&A Participants

While the negativity in the market tends to suggest headwinds for bank M&A in the near term, banks should continue to plan for M&A, albeit with some slightly different considerations.

If your bank is party to an announced M&A deal, consider the following.

- If the transaction involves publicly-traded stock consideration, consider the messaging to shareholders around the likely decrease in transaction value. Affirmative shareholder votes may no longer be a foregone conclusion.
- Consider whether updated fairness opinions are advisable.
- Review fiduciary out clauses so that deal participants are prepared if a competing, unsolicited bid is made to acquire the seller.
- Consider whether the materials delivered to seller shareholders adequately disclose any unique risks to the combined institution related to the current market, or whether the risk factors should be updated.

If you are pursuing an M&A negotiation during the virus-related upheaval, consider the following specific legal items in addition to the focused business diligence that should take place.

- In general, negotiations should be more focused on current realities than on precedent transactions.
- Caps and collars for equity-based consideration should be considered; however, we expect those to be difficult to negotiate amid current volatility.
- Representations and warranties should be tight enough to give the parties comfort that material issues have been disclosed, and bring-down requirements for closing should confirm that no new material issues have arisen.

- Material Adverse Effect/Material Adverse Change definitions should be carefully negotiated to capture or exclude impacts of the virus as appropriate.
- For deals involving publicly-traded buyer stock, termination provisions based upon changes in value should also be carefully negotiated. In a typical transaction, a "double trigger" termination provision will be used, which will provide that BOTH a material (typically 15-20%) decline in buyer stock price on an absolute basis and a material decline relative to an appropriate index will give the seller a termination right. Sellers should consider whether that protection is adequate, and buyers should push for the ability to add consideration in order to keep the deal together.
- Finally, fiduciary outs should be carefully negotiated. Many practitioners believe that such provisions are standard and should be included as a matter of right for the seller. However, not all states view these provisions in the same manner as Delaware, and even if so, there are many potentially significant differences in how the provisions are drafted from one deal to the next.

While M&A is challenging in the current environment, we believe there will be ample opportunities, particularly for cash buyers that can demonstrate patience. Credit marks will be complex if the current uncertainty continues, but valuable franchises may be available at attractive prices in the near future.

Banks as Consumers

Banks also have a role to play as economic consumers. First, expense discipline will remain a top priority, and banks should carefully bid any long-term commitments they are making on the expense side. Moreover, banks should understand risks associated with third parties and the manner in which they are addressing virus concerns. Critical vendors should have satisfactory pandemic plans in place to ensure they can continue to provide needed services to banks.

Further, banks are also consumers of cash. There are divergent views on the impact the virus has on the role of cash in the economy. On one hand, many consumers have the view that they would prefer not to handle cash given that it could be a medium for transferring germs (be sure to outfit tellers with hand sanitizer). On the other hand, some believe cash will be in higher demand if there is prolonged economic distress and that a currency quarantine by the Federal Reserve could cause a shortage. In either case, banks should consider their needs for vault cash to ensure they have enough.

Banks as Corporate Citizens

Concerns around the Coronavirus are gripping many businesses and homes. Banks, as leaders in the economic communities they serve, have a role to play in ensuring the impact of the virus, or fear of the virus, is mitigated to the extent possible. To that end, banks should take the following actions.

- Engage board members in determining top priorities as it relates to the virus. These priorities may go beyond concern for the health of employees and customers or for the financial health of the bank and its borrowers. Even social priorities should be identified and documented.
- Educate communities on the data related to the virus, as well as the range of outcomes on the impact to businesses and households from economic factors related to the virus.

- Educate consumers of the potential impact of their financial choices. For example, the 15-year mortgage rate will be tantalizing to a person with growing income, but banks should ensure he or she models the impact of a higher payment against a decline in income.
- While annual meetings of shareholders can be excellent opportunities to engage them in meaningful discussion about the bank, consider that many organizations are advising against large group gatherings. Subject to state law and the bylaws of the institution, shareholder meetings can be held virtually, and in any case, a recorded presentation related to the affairs of the bank can be made available to shareholders.

While we are hopeful that the impact of COVID-19 will be limited, we encourage banks to consider these items as they plan for a widely varied set of potential effects of the virus. We certainly do not wish to instill fear or negativity but believe that preparation for adverse scenarios is the best way to manage them. We are in contact with clients across the country regarding new challenges each day, and we welcome your call to discuss the current environment.

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