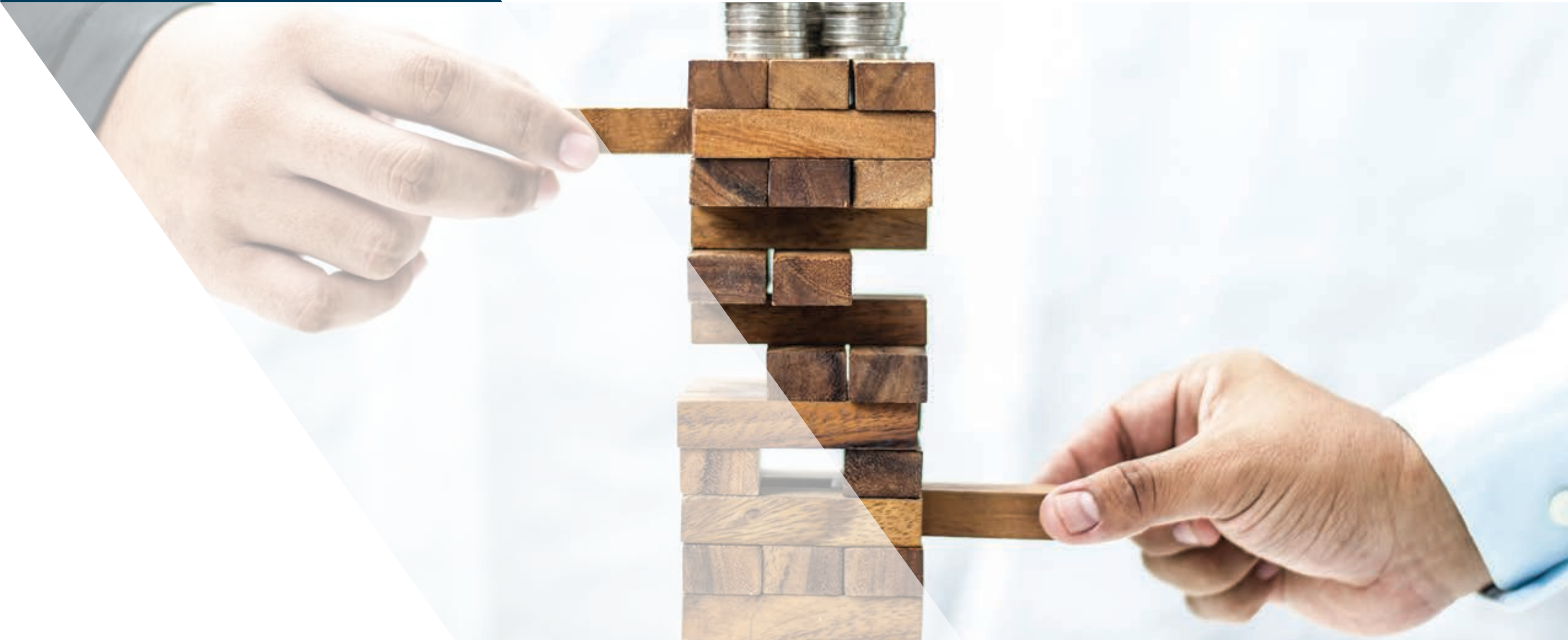
P&G Banking ADVISOR

Spring 2017



MANAGING ASSET CONCENTRATIONS DEMANDS A BALANCED APPROACH

SHOULD THERE BE NATIONAL BANK CHARTERS FOR "FINTECH" COMPANIES?

WHAT BENCHMARKING CAN DO FOR BORROWERS

BANK WIRE

P&G Associates

www.pandgassociates.com 877.651.1700

MANAGING ASSET CONCENTRATIONS DEMANDS A BALANCED APPROACH

When it comes to asset concentrations, community banks face a sort of "Catch 22" dilemma: On the one hand, concentrated exposure to certain types of loans, collateral or borrowers increases risk, violating the precept that you shouldn't put all your eggs in one basket. On the other hand, community banks, by definition, exist to serve their communities. Naturally, this can lead to high concentrations in local commercial real estate (CRE) and in industries prevalent in the area, such as agriculture, forestry, energy, technology, manufacturing or fishing.

RISK VS. REWARD

Asset concentrations increase a bank's risk by exposing it to significant potential losses. This makes it vulnerable to significant losses in the event of a local industry or economic downturn. But that doesn't mean that banks should avoid such concentrations at all costs. On the contrary, asset concentrations enable banks to better serve their communities by taking advantage of local industry expertise and market knowledge. The key to managing asset concentrations is to take a balanced approach that weighs the risks against the benefits — and to implement measures to mitigate those risks.

Here are some best practices banks should consider when addressing asset concentrations:

Review credit risk management policies. Evaluate your credit risk management policies, keeping in mind that asset concentration risks are felt well beyond the area of concentration. Suppose a bank has a heavy concentration of loans to businesses in a particular industry. A downturn in that industry could not only affect the ability of businesses in the industry to repay their loans, but could also make it harder for individuals who work in the industry to repay their auto loans or mortgages.

So it's critical to consider the impact of asset concentrations on your entire loan portfolio and to implement policies to address the elevated risk. Such policies might include:

- Tightening underwriting standards,
- Placing caps on asset concentrations,
- Conducting global cash-flow analyses,
- Stress testing, and
- Monitoring loans carefully.

Evaluate capital and reserves. Ensure that your bank's level of capital and reserves is commensurate with its concentration risk. If your bank has a significant concentration of loans in a particular industry, market or loan type, it's important to consider the relationships among these loans when evaluating the sufficiency of your capital and determining an appropriate allowance for loan and lease losses (ALLL).

Take a judicious approach to diversification. An obvious solution to a risky asset concentration is to diversify. But

CRE CONCENTRATIONS: WHAT ARE EXAMINERS LOOKING FOR?

In 2015, the Federal Reserve, FDIC and OCC issued a joint *Statement on Prudent Risk Management for Commercial Real Estate Lending*. According to the statement, banks with high CRE concentrations should, among other things:

- Establish adequate and appropriate loan policies, underwriting standards, credit risk management practices, concentration limits, lending strategies and capital adequacy strategies,
- Conduct global cash-flow analyses based on reasonable assumptions and perform stress testing of their CRE loan portfolio,
- Implement procedures for monitoring volatility in the real estate industry, and
- Implement processes for reviewing appraisal reports.

diversification presents its own risks, so it's important to handle the process carefully. For example, a bank with a heavy concentration of loans in an industry or geographic territory might diversify by making loans to businesses in other industries or territories. But doing so would require the bank to venture out of its comfort zone into areas where it might not possess the same level of knowledge and expertise.

Look for ways to diversify *within* a particular industry. For example, a bank with a high concentration of agricultural loans should consider lending to both crop producers, such as corn or soybean farmers, and livestock producers. This can mitigate the bank's risk because economic and other external forces that hurt one industry segment may help the other. A decline in crop prices, for instance, would harm crop producers but it would benefit livestock producers by reducing their feed costs.

Another diversification strategy is to increase the size of your bank's securities portfolio. Doing so instantly shrinks the bank's loan-to-asset ratio. (A high ratio is often a red flag.) But keep in mind that investing in securities poses problems of its own and may divert capital away from the community the bank serves.

REGULATORY GUIDANCE

Federal banking regulators have long been concerned about asset concentrations, particularly concentrations of CRE. In 2006, for example, before the subprime mortgage meltdown that contributed to the U.S. financial crisis, the major federal banking agencies issued guidance on the risks associated with concentrations of CRE loans. And in 2011, the Federal Reserve issued *Supervisory Expectations for Risk Management of Agricultural Credit Risk*, which outlines minimum risk-management practices for banks with significant agricultural exposure.

More recently, in 2015, banking regulators issued a joint statement reiterating the concerns raised in 2006 and outlining supervisory expectations regarding CRE concentrations. (See "CRE concentrations: What are examiners looking for?" above.)

STRIKE A BALANCE

It's important for community banks to address the risks that asset concentrations present. At the same time, they should recognize the benefits these concentrations provide to the community, and develop risk management practices that strike a balance between the two. ■

SHOULD THERE BE NATIONAL BANK CHARTERS FOR "FINTECH" COMPANIES?

The Office of the Comptroller of the Currency (OCC) is considering issuing special-purpose national bank charters to financial technology (fintech) companies, such as online lenders, payment processors and digital currency firms. This initiative has been criticized both by community banking advocates concerned about unfair competition and state banking regulators who fear their authority will be preempted.

OCC: IT'S IN THE PUBLIC INTEREST

According to an OCC white paper outlining its proposal, granting charters to fintech companies is in the public interest because:

1. Applying a bank regulatory framework to fintech companies will help ensure that they operate in a safe and sound manner,
2. The OCC's uniform supervision over national banks, including fintech companies, will promote consistency and ensure consumers are treated fairly, and
3. Providing fintech companies with a path to becoming national banks will make the federal banking system stronger by a) ensuring their safe and sound operation and b) promoting fair access and innovation.

Fintech companies welcome the proposal because it would relieve them of the burdens associated with state-by-state licensing requirements and regulatory frameworks.

MUST-HAVES FOR A FINTECH COMPANY

To be eligible for a special-purpose national bank charter, a fintech company would have to conduct at least one of these three core banking functions: 1) receiving deposits, 2) paying checks, or 3) lending money. In

addition, it would have to meet certain "baseline supervisory expectations," including having:

- A robust, well-developed business plan reflecting a commitment to fair access to financial services,
- A governance structure that's commensurate with the risk and complexity of its activities,
- Minimum and ongoing capital levels and liquidity commensurate with the risk and complexity of its activities,
- An effective compliance risk management program, and
- Well-developed recovery and exit strategies.

The white paper also describes the rules and standards that apply to special-purpose national banks and outlines the charter application process. At press time, the OCC was considering comments on its proposal.

COMMUNITY BANK REACTION

Many in the community banking industry are worried that granting special-purpose national bank charters to fintech companies will give them an unfair competitive

advantage. In a comment letter, the Independent Community Bankers of America (ICBA) said that it welcomes changes that will encourage innovation and make it easier for community banks to collaborate with fintech firms. (Many community banks see partnerships with fintech companies as a cost-effective strategy for adopting technological innovations that will help them compete with larger banks.) But the ICBA also expressed strong concern about issuing such charters "without spelling out clearly the supervision and regulation that these chartered institutions and their parent companies would be subject to."

The OCC's white paper states that special-purpose national banks are "subject to the same laws, regulations, examination, reporting requirements and ongoing supervision as other national banks." But, as the ICBA points out, there may be some exceptions. For example, nondepository fintech banks wouldn't be subject to the Bank Holding Company Act, raising the possibility that large commercial entities would be allowed to own banks as subsidiaries, thus creating worrisome conflicts of interest.

In addition, the ICBA argues that the OCC's proposal doesn't clearly define the scope of fintech companies eligible for charters, nor does it adequately define the regulatory capital, liquidity and other requirements that would apply.

STAY TUNED

Community banks should monitor the OCC's continuing exploration of charters for fintech companies and evaluate the potential impact on their business strategies. Regardless of the outcome, community banks should explore partnerships with fintech companies as a strategy for making cutting-edge banking technology available to banks' customers. ■

WHAT BENCHMARKING CAN DO FOR BORROWERS

Benchmarking is a useful tool for companies attempting to gauge their financial performance vis-à-vis similar companies in their industry. It involves comparisons between a company's performance and industry norms or best practices. But borrowers often don't engage in the benchmarking process, whether it's because they're too bogged down with daily operations or are unfamiliar with resources.

Lenders can add value and protect themselves from financial distress by introducing borrowers to benchmarking. This hypothetical example illustrates how benchmarking works for businesses.

AN UNEXPECTED BONUS

When Tom Smith switched banks to consolidate his company's debt and lower its interest rates, he

received an unexpected bonus — financial insight — from an unexpected source: his new banker.

As part of its standard due diligence protocol, the banker benchmarks each borrower's financial statements against Risk Management Association industry norms. Benchmarking, a powerful analytical tool, compares a company's performance with industry

norms and best practices. If a borrower fails to measure up, the owner receives a friendly follow-up call.

When the banker phoned Tom, she pointed out that his company's days-in-receivables were 15 days longer than the industry average and its days-in-inventory was nearly double the norm.

Tom was defensive: "You bankers need to spend some time in the real world! Our collections have been around 65 days since 2005. Customers won't pay faster. Small businesses can't afford to push customers — or we'll lose them!"

NO MORE EXCUSES

Having heard every excuse in the book, the banker pointed out that her portfolio included other borrowers in the same industry, of roughly the same size, that matched the benchmarks. Although Tom's performance didn't violate any loan covenants, she recommended he consult a CPA to get his company's asset management back on track.

Thanks to the banker's insight, Tom's average collection period is now down to 52 days. He's also being trained on inventory management software to assess safety stock (a level of extra stock maintained to mitigate risk of stockouts) and reorder points. And he's freed up cash to spend on new equipment and pay shareholders an unexpected dividend.

PART OF THE STORY

Changes in a borrower's performance over time tell only part of the story. Just because a company has survived for 25 years with a 65 days-in-receivable ratio doesn't necessarily mean it's healthy. A collection period of 65 days is unacceptable if competitors collect in 50 days.

Owners and lenders need to gauge how others in the industry fare in terms of asset management, growth, profitability and debt coverage. Major expenses worthy of comparison include rent and management compensation, especially if paid to related parties.

No universal benchmarks apply to all types of businesses. So it's important to seek data sorted by industry, size and geographic location, if possible. Encourage borrowers to share the data they receive from trade journals, conventions or local roundtable meetings.

Absent industry-specific data, there are several benchmarking resources you can consult, such as MicroBilt's Integra Financial Benchmarking Data, Dun & Bradstreet's Industry Norms and Key Business Ratios, ValuSource's IRS Corporate Ratios, and Risk Management Association's Annual Statement Studies®.

Benchmarking data has its limits, and comparisons may be imperfect. But it usually provides some insight, no matter how small a niche a borrower's operations may be.

OTHER FACTORS

Ratios also change over time. For example, if more competitors enter the marketplace, collections might slow and margins narrow. That's because the more suppliers there are in an industry, the less control those suppliers have over their customers.

Other factors that affect ratios include regulations, technology and economic conditions. Use current benchmarking data to avoid setting unreasonable goals. Also recognize that benchmarking is a continuous process, not a one-time event.

A WIN-WIN SITUATION

Lenders who offer guidance on the ins and outs of benchmarking and other professional tools will help their borrowers stay competitive within their industries in the long run. Borrowers who learn techniques for improving performance and achieving success will generate a win-win situation for themselves — and their lenders. ■

BANK WIRE

GET READY FOR NEW MORTGAGE SERVICING RULES

The Consumer Financial Protection Bureau (CFPB) in August 2016 issued its final Mortgage Servicing Rule, which amends the mortgage servicing provisions of Regulation X, under the Real Estate Settlement Procedures Act, and Regulation Z, under the Truth in Lending Act. Most of the amended provisions take effect October 19, 2017, but provisions related to successors in interest and periodic statements for borrowers in bankruptcy take effect April 19, 2018.

The CFPB also has published an updated version of its Mortgage Servicing *Small Entity Compliance Guide*, which incorporates the final Mortgage Servicing Rule. You can find Version 3.0 of this guide by visiting consumerfinance.gov. Click on "Policy & Compliance" / "Compliance & Guidance" / "Implementation and Guidance" / and "Title XIV Rules: Mortgage Servicing." ■

KEEP AN EYE ON BLOCKCHAIN

In the world of financial services technology, few terms have received more hype than "blockchain." And though widespread implementation of blockchain is several years away, community banks should become familiar with the technology and keep an eye on future developments. (A good resource for blockchain information is the Community Bank Blockchain Alliance at cbblockchain.org.)

Best known as the technology that makes Bitcoin possible, blockchain's potential uses extend far beyond digital currencies. Simply put, a blockchain is a distributed database, or ledger, which is shared among thousands, or even millions, of computers (called "nodes") rather than being housed on one central server. Because the ledger isn't under the control of any single party — transactions aren't added until verified by a process of consensus — it's highly resistant to errors, fraud or tampering. And the technology uses encryption and digital signatures to protect participants' identities.

Given these features, blockchain establishes trust without the need for intermediaries to settle or authenticate transactions. This has the potential to make a variety of banking transactions dramatically more efficient, saving banks, and their customers, billions of dollars. ■

IS YOUR WEBSITE ACCESSIBLE TO THE DISABLED?

Recently, there's been an increase in litigation under the Americans with Disabilities Act (ADA). These lawsuits allege that companies' websites (including some banks' websites) are inaccessible to people with visual and hearing impairments. The ADA applies to "public accommodations," including banks and other financial institutions. Unfortunately, there's some uncertainty about the features a website must offer to avoid violating the ADA. And the U.S. Department of Justice (DOJ) doesn't expect to publish regulations on the subject until next year.

In the meantime, to avoid ADA claims, banks should evaluate the accessibility of their websites to the visually and hearing impaired. DOJ officials have suggested that a commercial website would likely comply with the ADA if it satisfies "Level AA" of the World Wide Web Consortium's *Web Content Accessibility Guidelines 2.0*. ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2017 CBAsp17

P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

P&G's uniqueness is characterized by its experienced staff and partners. Their hands-on involvement on each engagement provides our clients with a wide range of skills, experience and industry expertise. We employ the use of Subject Matter Experts — designated individuals performing audits in their specific field of expertise. The use of such professionals provides a unique value-added approach that is both efficient and productive.

We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

We pride ourselves in our ability to provide effective and practical solutions that are commensurate with our clients' needs by emphasizing high-quality personalized service and attention. Our services are truly customized.

For **Solutions** *to your internal audit needs, please contact our service coordinators at (877) 651-1700, or log-on to www.pandgassociates.com to learn more.*

www.pandgassociates.com

Headquarters:
646 US Highway 18
East Brunswick, NJ 08816

Offices:
New York, NY
Philadelphia, PA
Chicago, IL
Miami, FL