

P&G Banking

A D V I S O R

Spring 2019



WHAT DOES THE NEW LEASE ACCOUNTING STANDARD MEAN FOR BANKS?

STAYING AHEAD OF THE GAME

Review your real estate valuation program

FEDERAL RESERVE FOCUSES ON EMERGING RISKS

BANK WIRE

P&G Associates

www.pandgassociates.com 877.651.1700

WHAT DOES THE NEW LEASE ACCOUNTING STANDARD MEAN FOR BANKS?

The Financial Accounting Standards Board's (FASB's) new lease accounting standard, nearly 13 years in the making, finally takes effect this year for public business entities — and fiscal years beginning after December 15, 2019, for other organizations. By eliminating off-balance-sheet treatment for most operating leases, the new standard may affect banks in two ways: First, it will cause many customers' balance sheets to swell, which may cause some customers to violate loan covenants. Second, it will have an impact on banks' own balance sheets, which may affect their capital ratios.

A BRIEF REFRESHER

Under the previous lease accounting standard, leases were classified either as "capital" or "operating" leases. Generally, capital leases transfer ownership of assets to the lessee, while operating leases transfer the right to use assets during the lease term. Capital

leases are reported on the balance sheet, but operating leases are not — though they're disclosed in the financial statement footnotes.

EXPENSE RECOGNITION UNDER THE NEW STANDARD DEPENDS ON A LEASE'S CLASSIFICATION.

The new standard retains the distinction between operating and capital leases (now called "finance" leases), but requires all leases, other than short-term operating leases (those with terms under one year), to be reported on the balance sheet. For each lease on the balance sheet, a lessee will record 1) a liability reflecting its obligation to make lease payments, and 2) an asset reflecting its legal right to use the leased property (a "right-of-use" or ROU asset). Both are based on the present value of minimum payments under the lease, with adjustments to the ROU asset for certain pre-payments, incentives and costs.

Expense recognition under the new standard depends on a lease's classification. For finance leases, organizations amortize the ROU asset, generally on a straight-line basis, and recognize interest expense and liability repayment over the life of the lease, similar to



a loan. For operating leases, organizations generally recognize lease expenses on a straight-line basis, with certain adjustments.

IMPACT ON LOAN COVENANTS

As the new standard takes effect, borrowers with significant operating leases will experience an immediate increase in assets and liabilities on their balance sheets. As a result, some loan customers may be in technical violation of loan covenants that place limits on their overall debt or require them to maintain certain debt-related financial ratios. Banks should review all loan covenants to evaluate the impact of the new standard.

Whether it will have an adverse impact on borrowers depends in part on how “debt” is defined in the loan documents. The FASB, recognizing that the new standard might create issues with loan covenants, provided for operating lease liabilities to be characterized as “operating liabilities,” rather than “debt.” This action should prevent violations of some commonly used loan covenants. However, covenants that rely on financial ratios that include operating lease liabilities may present a problem.

Banks should consider modifying existing loan covenants to avoid unnecessary breaches and revise covenants going forward to reflect the new lease accounting standard. (See “Adding flexibility to your loan covenants” at right.) It’s important to recognize that the addition of operating leases to the balance sheet doesn’t change a borrower’s underlying economic situation, cash flow or ability to repay a loan. After all, in most cases, the borrower has been making these lease payments for years — the new standard merely changes the way they’re reported.

IMPACT ON BANK CAPITAL

For most community banks, the new lease accounting standard isn’t likely to have a significant impact on regulatory capital. But it may affect some banks with substantial operating leases for facilities, equipment and other fixed assets.

ADDING FLEXIBILITY TO YOUR LOAN COVENANTS

The new lease accounting standard demonstrates how changes in financial reporting can affect compliance with loan covenants, even if the underlying economics are the same. As you review existing loan documents and negotiate new ones, consider incorporating covenant models that provide the flexibility needed to adapt to future changes in Generally Accepted Accounting Principles (GAAP). Two common approaches are:

1. Frozen GAAP. Covenants that contain a frozen GAAP clause provide that changes in financial ratios resulting from changes in GAAP won’t cause a violation. In other words, applicable GAAP is frozen as of the date the loan is made. The *problem* with this approach is that continuing to apply GAAP that’s in effect at the time the loan agreement is executed, regardless of future changes, essentially requires two sets of books: one to comply with GAAP and one to track compliance with loan covenants.

2. Semifrozen GAAP. A semifrozen GAAP clause requires the parties to renegotiate the loan covenant if a change in GAAP alters financial ratios. This approach avoids the need to keep two sets of books. But it requires the parties to amend the covenant to accommodate their respective needs while reflecting changes in GAAP.

This is because the addition of ROU assets to the balance sheet may affect the ratio of capital to risk-weighted assets. The ratio is used to determine capital adequacy.

SOME RECOMMENDATIONS

All banks should review their loan documents and modify them if necessary to prevent inadvertent violations of loan covenants. They should also assess the impact of the new standard, if any, on their regulatory capital levels. ■

STAYING AHEAD OF THE GAME

Review your real estate valuation program

The value of real estate collateral is likely fundamental to the value of your loan portfolios. So it's important to stay on top of real estate value fluctuations and obtain periodic appraisals according to the rules. You also need to understand interagency guidelines, maintain program independence, use selection criteria for valuers and become familiar with appraisal standards. Doing all this can keep you ahead of the game.

WHAT ARE THE INTERAGENCY GUIDELINES?

Start your evaluation by revisiting the kingpin of any valuation program, the *Interagency Appraisal and Evaluation Guidelines*. They apply to appraisals and evaluations for all real estate-related financial transactions originated or purchased by regulated institutions, whether for the institutions' own portfolios or as assets held for sale. The guidelines cover residential and commercial mortgages, capital markets groups, and asset securitization and sales units.

Most transactions valued at more than \$250,000 require appraisals, though certain transactions — listed in Appendix A to the guidelines — are exempt. In addition to the exclusion for transactions at or below the \$250,000 threshold, exceptions include:

- ▶ Business loans secured by real estate for less than \$500,000 (the \$500,000 limit for commercial loans took effect on April 9, 2018) whose source of repayment is from other than the rental income or sale of the real estate,
- ▶ Extensions of existing credits,
- ▶ Loans not secured by real estate, and
- ▶ Transactions guaranteed or insured by the U.S. government.

The exemptions are limited, so be sure to scrutinize transactions to determine whether risk factors or other



circumstances make an appraisal necessary. Some exempt transactions require a less formal evaluation.

IS YOUR PROGRAM INDEPENDENT?

Your institution is responsible for developing an effective collateral valuation program. First, consider the *independence* of your program, which should be isolated from influence by your loan production staff. Individuals who order, review and accept appraisals or evaluations should have reporting lines independent of the production staff as well. Appraisers and individuals performing evaluations ("evaluators") need to be independent of loan production and loan collection and obviously should have no interest in the transaction or property.

Special rules apply to smaller institutions that lack the staff needed to separate their collateral valuation programs from the production process. For mortgages and other loans secured by a principal dwelling, review amendments to Regulation Z that impose strict independence and conflict-of-interest requirements on appraisers.

WHAT ARE THE SELECTION CRITERIA FOR VALUATORS?

Next consider *how* you select valuers. Set criteria for selecting, evaluating and monitoring appraisers

and evaluators, and for documenting their credentials. Among other things, ensure that those selected are qualified, competent and independent and that appraisers hold appropriate state certifications or licenses.

Select and engage appraisers *directly* (though appraisals prepared for other institutions may be used if specific rigorous requirements are met). Approved appraiser lists are permitted, provided you establish safeguards to ensure that list members continue to be qualified, competent and independent.

WHAT ARE THE MINIMUM APPRAISAL STANDARDS?

Then make sure that your appraisals conform to the Uniform Standards of Professional Appraisal Practice, although safe and sound banking practices may call for stricter standards. Written reports should provide sufficient detail — according to the transaction’s risk, size and complexity — to support the credit decision.

Appraisers should analyze appropriate deductions and discounts (detailed in Appendix C of the guidelines) for proposed construction or renovation, partially leased buildings, nonmarket lease terms and tract developments with unsold units.

WHAT ARE SOME OTHER FACTORS?

In addition to these touchstones, your program should facilitate credit decisions by ensuring the timely receipt and review of appraisal or evaluation reports. It also should provide criteria for determining whether existing appraisals or evaluations may be used to support subsequent transactions.

Moreover, your valuation program should have in place internal controls that promote compliance. And it should contain standards for monitoring collateral values and for handling transactions not otherwise covered by appraisal regulations.

If you outsource valuation functions, your institution remains responsible for all appraisals and evaluations. The interagency guidelines discuss the resources, expertise, controls and due diligence procedures your institution needs to identify, monitor and manage risks associated with these outsourcing arrangements.

IS IT WORKING?

The only way to ensure that your real estate collateral is sound is to set up an effective, efficient and comprehensive program. You’ll also need to review it regularly and adjust as needed to keep it on the right track. ■

FEDERAL RESERVE FOCUSES ON EMERGING RISKS

Late last year, the Federal Reserve released its inaugural *Supervision and Regulation Report*. The report is designed to summarize banking conditions and the Fed’s supervisory and regulatory activities.

WORTH NOTING

Here are some highlights from the report:

Banking system conditions. The Fed reports that the U.S. banking system is generally strong, that loan growth remains robust, that the volume of nonperforming loans

has declined over the last five years, and that overall profitability is stable. Banks continue to maintain high levels of quality capital and have significantly improved their liquidity since the financial crisis.

Large financial institution (LFI) soundness. According to the report, the safety and soundness of LFIs continues to improve. Capital levels are strong and significantly higher than before the financial crisis. Recent stress test results demonstrate that LFIs’ capital levels would remain above regulatory minimums even after a hypothetical severe global recession.

Still, some LFI continue to work to meet supervisory expectations in specific risk management areas. Those with “less than satisfactory” ratings generally exhibit weaknesses in compliance, internal controls, model risk management, operational risk management, information technology (IT) infrastructure or Bank Secrecy Act (BSA) / anti-money laundering (AML) programs. According to the report, to improve consistency and efficiency, supervisors will 1) focus on horizontal supervisory examinations within portfolios, and 2) review emerging risks and actions taken to address previously identified weaknesses.



Regional and community banking organization liquidity risk. The Fed reports that most regional banking organizations (RBOs) and community banking organizations (CBOs) are in satisfactory condition, and that 99% are “well capitalized.” Although liquidity risk is generally low or moderate for RBOs, examiners have observed some deterioration of liquidity positions.

The Fed also has identified opportunities for improving RBO risk management. In 2019, the Fed’s RBO supervisory priorities include:

- ▶ Credit risk (concentrations of credit, commercial real estate [CRE] and construction and land development, and underwriting practices),
- ▶ Operational risk (merger and acquisition risks, IT, and cybersecurity), and
- ▶ Other risks (sales practices and incentive compensation and BSA/AML).

CBOs, the Fed observes, are in “robust financial condition,” with high capital levels and low-to-moderate liquidity risks. But like RBOs, CBOs have experienced “a slight uptick” in liquidity risks. Supervisors continue to focus on three areas of emerging risk: 1) management of concentrations of credit — specifically, CRE, agriculture, and oil and gas, 2) the impact of rising interest rates, and 3) increased liquidity risk.

CBO supervisory priorities for 2019 include:

- ▶ Credit risk (concentrations of credit, CRE and construction and land development, and agriculture),
- ▶ Operational risk (IT and cybersecurity), and
- ▶ Other risks (BSA/AML and liquidity risk).

According to the report, the Fed also has made it a priority to modernize and increase the efficiency of the examination process to reduce the burden on community banks. A key part of this effort is the Bank Exams Tailored to Risk program. Under that program, each bank is classified into a low-, moderate- or high-risk tier. The classification provides examiners with a starting point for determining the scope of work, including the extent of transaction testing and other examination procedures. Examiners have the discretion to consider qualitative factors and apply their own judgment in confirming or adjusting the risk tiers.

A VALUABLE TOOL

The Fed’s inaugural *Supervision and Regulation Report* examines trends going back to the financial crisis. Future reports will focus on developments since the previous report. Taken together, these reports provide banks with a valuable tool for keeping their fingers on the pulse of the banking industry and identifying emerging risks. ■

BANK WIRE

CECL: BANKING AGENCIES OFFER REGULATORY CAPITAL RELIEF

The federal bank regulatory agencies recently finalized a rule that offers banks relief from the regulatory capital impact of the new Current Expected Credit Loss (CECL) standard. CECL discards the traditional incurred-loss model for recognizing credit losses in favor of a forward-looking approach. That is, banks will recognize an immediate allowance for all expected losses over the life of loans and other financial assets covered by the standard.

For some banks, adoption of CECL will negatively affect regulatory capital. Although the actual impact depends on a bank's particular circumstances, many banks will experience an increase in allowance levels and a reduction in the retained earnings component of equity. This combination will lower their common equity tier 1 capital.

The final rule gives banks the option to phase in the day-one adverse regulatory capital effects of implementing CECL over a three-year period. ■

A BYOD POLICY PROTECTS BANKS

These days, the vast majority of your employees have smartphones. Use of these devices to send and receive work-related emails and other communications, and



to access the bank's files and other network resources, can boost productivity. But the ensuing security concerns have led some banks to prohibit employees from using their own devices for bank business. Although an outright ban can be hard to enforce, setting a bring-your-own-device (BYOD) policy enabling the bank to control these devices and manage the risk may be a better approach.

A BYOD policy should, among other things:

- ▶ Provide for management approval and registration of all mobile devices that will access the bank's servers,
- ▶ Require employees to maintain up-to-date virus protection, authentication and encryption software on mobile devices,
- ▶ Require employees to use strong passwords and other security controls to access mobile devices and the bank's servers,
- ▶ Specify what type of information can be stored on or transmitted by mobile devices,
- ▶ Allow the bank to remotely wipe a device clean if it's lost or stolen, and
- ▶ Require employees to provide written consent to comply with the written security procedures before using the device for bank business.

Consider using mobile device management (MDM) software to manage employees' devices and implement controls to protect the bank's information. ■

REGULATORS APPROVE LENGTHENED EXAMINATION CYCLE

On January 17, the federal bank regulatory agencies finalized a rule expanding the availability of an 18-month, on-site examination cycle for qualifying banks with less than \$3 billion in total assets (up from \$1 billion). The agencies reserved the right to impose more frequent examinations if deemed "necessary or appropriate." ■

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. ©2019



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