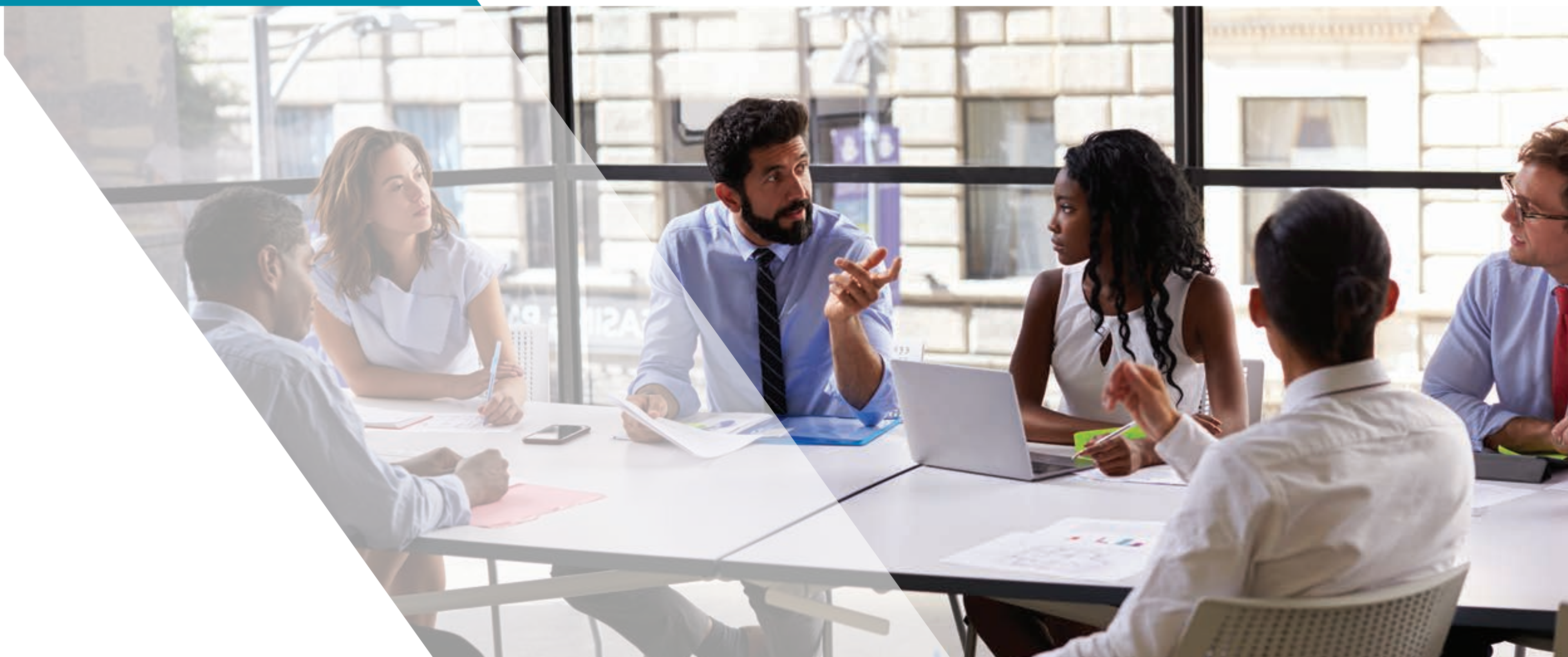
P&G Banking ADVISOR

Summer 2017



P&G Associates

www.pandgassociates.com 877.651.1700

IMPLEMENTING CECL: FEDERAL REGULATORS OFFER GUIDANCE

The Current Expected Credit Loss (CECL) model — viewed by many as the biggest change in the history of bank accounting — was finalized in June 2016 and takes effect beginning in 2020. Nonpublic business entities (non-PBEs), including most community banks, must implement the new model for fiscal years beginning after December 15, 2020, and for interim periods in fiscal years beginning after December 15, 2021.

Recently, federal banking regulators issued a joint statement to answer frequently asked questions (FAQs) about the new accounting standard. The FAQs explain CECL and outline the steps banks should take to plan and prepare for the transition to, and implementation of, the new standard.

THE NEW STANDARD IN A NUTSHELL

The new standard, found in Accounting Standards Update (ASU) No. 2016-13, discards today's incurred-loss model, which delays recognition of credit losses until they become "probable," in favor of a forward-looking approach. Banks now will recognize an immediate allowance for all expected credit losses over the life of loans held for investment, held-to-maturity debt securities and other covered financial assets.

To estimate expected losses, banks will consider a broader range of data than they do under current standards, including historical and current information. For many banks, implementing the new standard will cause them to increase their allowances for loan and lease losses (ALLL), which will have an impact on earnings and capital.

10 STEPS TO TAKE

The FAQs encourage banks to prepare for CECL implementation by taking these 10 steps:

1. Become familiar with the new accounting standard. Educate the board and appropriate staff about how CECL differs from the current methodology.

2. Determine the applicable effective date. The effective date for non-PBEs is noted above. Institutions that are SEC filers or otherwise satisfy the definition of PBE (see "BankWire" on page 7) must implement CECL earlier.

3. Create a timeline. Determine the steps and timing needed to implement the new standard.

4. Identify the functional areas that should participate in implementation (for example, accounting/finance, audit, credit risk management, operations, IT). A good way to start is to review your current process for determining credit losses and establishing the ALLL, and identifying the departments and staff involved.

5. Discuss the new standard with the board, audit committee, external auditors, industry peers and

regulators. This will help determine an implementation strategy that's appropriate in light of your bank's size, activities and risk profile.

6. Identify existing ALLL and credit risk management practices that can be leveraged when applying the new standard. Use what you already have in place that doesn't need to change, and modify existing tools and processes as necessary.

7. Determine the allowance estimation method or methods to be used. The FAQs emphasize that CECL is scalable to institutions of all sizes. The regulatory agencies do not expect smaller, less complex institutions to adopt complex modeling techniques.

8. Identify currently available data and any additional data you need to collect and maintain going forward to implement the new standard. It's critical to begin collecting any new data as early as possible so you'll have time to accumulate the data you need to implement CECL. Your bank's data requirements will depend on the allowance estimation methods you select, but the FAQs provide examples of the types of data you may need to collect:

- Loan origination and maturity dates,
- Loan origination par amount,
- Initial and subsequent loan charge-off amounts and dates,
- Loan recovery amounts and dates, and
- Cumulative loss amounts for loans with similar risk characteristics.

9. Identify system changes needed to implement the new standard. These must be consistent with your chosen allowance estimation methods.

10. Evaluate and plan for the new standard's potential impact on regulatory capital. According to the FAQs, upon initial adoption CECL "will likely increase allowance levels and lower the retained earnings component of equity, thereby lowering common equity tier 1 capital for regulatory capital purposes." But the regulators emphasize that the actual impact will vary from institution to institution based on several factors, including existing allowance balances, portfolio mix, underwriting practices, institution and borrower locations, and current and expected economic conditions.

START PLANNING NOW

Although implementation of CECL is more than three years away for most community banks, it's a good idea to start the planning process now. Getting an early start is particularly important if your bank will need to adjust its data collection practices, modify its internal controls or update its IT systems to prepare for implementation. ■

SHOULD YOU BE STRESS TESTING YOUR CAPITAL?

In light of the Current Expected Credit Loss (CECL — see main article) model's potential impact on regulatory capital, banks should consider stress testing their capital. Stress testing can be a powerful tool for evaluating the impact of hypothetical adverse events on a bank's earnings, capital adequacy and other performance measures. The Office of the Comptroller of the Currency (OCC) considers annual stress testing or sensitivity analysis of loan portfolios to be a key component of sound risk management for community banks.

As part of your capital planning process, it's a good idea to use stress testing to evaluate the worst-case-scenario impact of CECL on your bank's capital adequacy. Armed with this information, you can determine whether to take steps to raise new capital or reduce risk as CECL's implementation date approaches.

SHOULD YOU TRIM THE TREE?

How to evaluate and improve branch performance

Many community banks depend on local relationships to prosper. Despite the increasing viability and importance of virtual banking, one of the best ways to nurture these relationships is through direct interaction at brick-and-mortar branches.

But banks need to monitor and evaluate branches on an ongoing basis to ensure they continue to perform well and are contributing to the overall health of the bank. Measuring branch performance, while difficult, is key to ensuring a bank's ongoing profitability.

ASSIGNING CUSTOMERS

A significant challenge in measuring branch performance is assigning customers to particular locations. Traditional measures (such as new accounts opened or teller activity) no longer suffice. Just because a customer opened an account at a branch doesn't necessarily mean that account should count toward the branch's performance.

MEASURING BRANCH PERFORMANCE, WHILE DIFFICULT, IS KEY TO ENSURING A BANK'S ONGOING PROFITABILITY.

What if the customer relocated? What if he or she uses more than one branch? What if the customer does everything online and doesn't visit branches at all? There are no easy answers to these questions, but, to get an accurate picture of branch performance, banks need to develop models that better reflect a branch's interactions with customers and its contribution to the bank's overall performance.

DEVELOPING STRATEGIES

Some banks are developing point systems to measure the value of products sold, customer service and retention. For example, core accounts like checking accounts generally are more valuable than CDs, which often constitute "hot money" — that is, funds frequently transferred between financial institutions in an attempt to maximize returns. The analysis might be different, however, if a checking account has a small average monthly balance or if a CD has a relatively long term.

For services, one set of point values might be assigned to transaction processing — such as cashing checks or accepting deposits — with higher values assigned to loans or consultative services.

According to financial services technology provider Fiserv, customers with one banking product stay with a bank around 18 months on average. The average relationship increases to four years for customers with two products and to almost seven years for customers with three products. So branches with more customers purchasing multiple products tend to contribute more value. And transfers of funds among branches affect branch profitability.

ANALYZING DIFFERENCES

Too often, banks' business development plans fail to reflect the sometimes dramatic differences between their branches' local markets. Many simply allocate their budgets uniformly among locations and demand that each branch achieve similar profitability and growth goals.

There are two problems with this approach. First, it establishes unachievable goals for branches in certain markets, while allowing other locations to coast. Second, it may cause a bank to miss opportunities to enhance branch performance.

A better approach is to benchmark the bank's performance against that of its peers. After identifying areas in which it's falling short, the bank can examine individual branches, analyze their local markets and develop strategies for enhancing performance.

It's important to analyze each branch's current customer base as well as the various commercial and consumer segments that make up its local market. Armed with this information, you can develop marketing strategies that make the most of each location's unique profitability and growth opportunities.

For example, a branch in an area with a lot of high-income consumers might target those consumers and also focus on cross-selling to existing customers. (Of course, it's important to keep in mind fair lending exposure and Community Reinvestment Act considerations.) As noted above, providing multiple products to customers improves retention rates. On the commercial side, analyzing local markets may reveal opportunities to serve previously untapped commercial sectors or business niches.

MAKE AN INFORMED DECISION

Branches can be essential to your bank's ability to thrive and grow. But to remain effective, they must continue to meet the needs of the local community. Periodic analysis of your branches can lead to more informed decisions about whether to reduce expenses by closing a branch — or develop new products and services it can offer to better serve customers. Either way, you win. ■

EXPLORE NEW BUSINESS LINES AND BOOST FEE INCOME

In an increasingly competitive environment, many community banks are exploring new business lines in an effort to expand their lending options and boost fee income. A few opportunities that might lead to improvements in your bank's bottom line include SBA lending, municipal finance and insurance premium financing.

SBA LENDING

The U.S. Small Business Administration (SBA) operates several programs designed to help small business owners grow or maintain their businesses. The SBA's two flagship lending programs — 7(a) and 504 — also offer significant benefits for community banks.

Under the 7(a) program, the SBA guarantees a portion (up to 75% or more) of loans to eligible small businesses. These loans, which can reach as high as $5 million, can be used for a variety of business purposes, such as:

- Acquiring or starting a business,
- Purchasing machinery, equipment or supplies,
- Improving land or buildings,
- Financing receivables,
- Augmenting working capital, or
- Refinancing existing debt (under certain conditions).

Benefits to banks that make 7(a) loans include:

Expanded customer base. The program allows banks to serve customers that wouldn't otherwise satisfy conventional underwriting criteria.

Improved risk management. The SBA's guaranty on 7(a) loans mitigates the lender's risk.

Increased lending business. In many cases, the guaranteed portion of a 7(a) loan doesn't count toward a bank's legal lending limit, helping it boost its lending capacity.

Reduced capital requirements. Guaranteed loans have a lower risk weight than unguaranteed loans for regulatory capital purposes, so 7(a) lending can make it easier for a bank to meet capital requirements.

Increased liquidity. Banks are allowed to sell the guaranteed portion of 7(a) loans into the secondary market, providing an alternative source of liquidity.

Under the 504 program, lenders partner with not-for-profit certified development companies (CDCs) to help small businesses expand and modernize by offering favorable financing for real property and major fixed assets. In a typical transaction, the lender and CDC each make a loan to a qualifying small business. The lender's loan usually is secured by a first lien covering 50% of project costs, while the CDC's loan is secured by a second lien covering up to 40% of project costs and backed by a 100% SBA-guaranteed debenture.

The 504 program benefits banks by creating opportunities to serve customers that would not otherwise satisfy conventional underwriting criteria. In addition, because banks enjoy a 50% loan-to-value (LTV) ratio, the program minimizes collateral risk. And, like 7(a) loans, 504 loans can be sold into the secondary market, providing an alternative liquidity source.

MUNICIPAL FINANCE

Community banks are increasingly pursuing opportunities to finance capital projects of state agencies, local governments and schools. Although yields on municipal loans tend to be lower than those of other types of loans, they generally enjoy higher credit quality.

They also enable community banks to diversify their business loan portfolios beyond commercial real estate. The added local visibility can attract new customers as well.

INSURANCE PREMIUM FINANCING

As the name suggests, premium financing involves lending money used by the borrower to pay life insurance premiums. The loan is secured by the policy's cash surrender value plus, if necessary, additional collateral (such as publicly traded securities or letters of credit).

Typically, these arrangements involve indexed universal life policies, which offer guaranteed minimum returns. This makes them safe assets that support high LTV ratios — even as high as 100% in some cases.

EXPLORE YOUR OPTIONS

Recently, *American Banker* listed the business lines discussed above, as well as equipment finance and senior care construction loans, as attractive opportunities for community banks. If your bank is pursuing new sources of loans and fee income, these business lines may be worth a look. ■

BANK WIRE

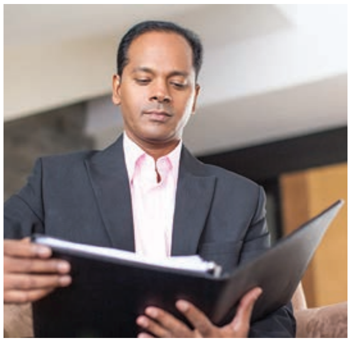
HOW DO YOU ATTRACT MILLENNIALS?

A 2016 survey commissioned by Kasasa (a provider of products and services to community banks) and conducted online by the Harris Poll provides insights into the banking preferences of Millennials. Here are a few highlights:

- 83% would switch to a bank that offered more or better rewards, such as a high interest rate on checking, cash back on purchases or ATM fee refunds.
- 65% would be more open to switching to a community bank if it offered mobile services, such as mobile apps or mobile check deposit.
- 93% say no-fees banking is important when choosing an institution for their everyday banking needs.
- 90% say convenient location is important when choosing an institution for their everyday banking needs. ■

WHAT GUIDANCE IS AVAILABLE ON MORTGAGE SERVICING RULES?

The Consumer Financial Protection Bureau's final mortgage servicing rules take effect on October 19, 2017 (though certain provisions don't kick in until April 19, 2018). Several resources are available to help bankers comply with these complex new rules. For example, the American Bankers Association (ABA) recently published its *Reference Guide to Mortgage Servicing*, which is free to ABA members. According to the ABA, the publication is "organized based on the lifecycle of a mortgage loan, making it easier to find information." In addition to a linked table of contents, the guide contains several quick-reference compliance aids, plus practical tips for compliance. The Independent Community Bankers of America (ICBA) also offers a free summary of the new rules. To find it at ICBA.org, search for "ICBAsummarymortgage" and choose the October 2016 article. ■



IS YOUR BANK A PUBLIC BUSINESS ENTITY?

Classification as a public business entity (PBE) can have a big impact on a bank's financial statements. For example, non-PBEs are exempt from certain GAAP requirements, usually have more time to adopt new accounting standards, may elect to follow some private company accounting alternatives and often enjoy less stringent disclosure requirements than PBEs.

Generally, under the FASB's definition, PBEs are SEC filers and other entities that have publicly traded securities. In addition, they include entities 1) that have one or more securities not subject to contractual restrictions on transfer, *and* 2) that are legally required to prepare U.S. GAAP financial statements and make them publicly available on a periodic basis.

Banks whose total assets exceed $500 million are subject to the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which requires them to file annual audited U.S. GAAP financial statements with the FDIC and make them publicly available upon request. If an FDICIA bank also has one or more securities not subject to contractual restrictions on transfer, it meets the definition of a PBE. ■

P&G Associates

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.*

P&G Associates

www.pandgassociates.com

Headquarters:
646 US Highway 18
East Brunswick, NJ 08816

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