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KEEPING CREDIT VIABLE DURING A CRISIS
CARES Act helps community banks assist their borrowers

TAKE STEPS NOW TO HANDLE LIQUIDITY RISK

WILL CECL AFFECT YOUR INCENTIVE COMPENSATION PLANS?

BANK WIRE

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KEEPING CREDIT VIABLE DURING A CRISIS

CARES Act helps community banks assist their borrowers

In response to the COVID-19 pandemic's negative impact on the U.S. and global economies, federal lawmakers have taken a number of steps to stimulate the economy and sustain credit flow — including passing the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which was signed into law on March 27. The act includes provisions to help community banks extend credit to struggling businesses and individuals.

WHAT ARE THE HIGHLIGHTS?

Here are some of the CARES Act provisions community banks should keep on their radar:

Capital relief. The CARES Act extends the benefits of the community bank leverage ratio (CBLR) election to a greater number of banks. Qualifying community banks that make the election are relieved of the obligation to make complex, expensive capital calculations.

Ordinarily, a qualifying bank must have a leverage ratio greater than 9% and meet certain other requirements. The act temporarily reduces the leverage ratio threshold to 8% until the earlier of the end of 2020 or the date the COVID-19 national emergency declaration terminates. The goal of this change is to make it easier for community banks to extend credit to struggling small businesses.

Greater flexibility to restructure debt. The act provides community banks with greater flexibility to restructure loans to borrowers affected by the COVID-19 pandemic without triggering the undesirable consequences of a "troubled debt restructuring" (TDR).

Generally speaking, a restructuring is a TDR if a bank, as a result of a borrower's financial difficulties, grants one or more concessions that it ordinarily wouldn't consider. These include reducing the interest rate, extending the maturity date at a below-market rate, or forgiving interest or principal.

If a restructuring is classified as a TDR, the bank must measure it for impairment, recognize a valuation allowance or loss if appropriate and, in most cases, place the subject loan on nonaccrual status. A TDR also can affect the bank's capital and invite additional examiner scrutiny or criticism.

IS YOUR BANK ENTITLED TO A REFUND OF PRIOR YEARS' TAXES?

The Coronavirus Aid, Relief, and Economic Security (CARES) Act temporarily relaxes restrictions on the ability to carry back net operating losses (NOLs) to offset taxable income in previous years. If your bank has an NOL this year, or suffered losses in the previous two years, there may be an opportunity to use those losses to reduce taxable income in previous years and claim a refund.

Ever since the Tax Cuts and Jobs Act of 2017 (TCJA) took effect, businesses haven't been allowed to carry back NOLs, though NOLs may be carried forward indefinitely. The TCJA also limited NOL deductions in a tax year to 80% of taxable income.

The CARES Act allows businesses with NOLs in 2018, 2019 or 2020 to carry back those losses up to five years. It also temporarily removes the 80% cap on deductions for losses generated in those years, making it possible for businesses with sufficient losses to offset all of their taxable income in a carryback year.

But the act allows banks, under specific circumstances, to avoid treating loan modifications as TDRs — even though they would otherwise be classified as such. To qualify, a loan must not have been more than 30 days past due as of the end of 2019 and the modification must be made between March 1, 2020, and the *earlier* of 1) 60 days after the COVID-19 national emergency declaration terminates, or 2) December 31, 2020.

This relief isn't available if the reasons for the modification are unrelated to the COVID-19 pandemic. So it's critical for banks to carefully document the decision-making process to demonstrate that concessions were made as a result of the pandemic's adverse impact on the borrower.

Increased business interest deductions. The act temporarily eases restrictions on borrowers' ability to deduct interest on business-related loans and credit lines. Current law imposes a cap on deductions of business interest generally equal to 30% of a borrower's adjusted taxable income (ATI). (This limit doesn't apply to businesses with average annual gross receipts of $25 million or less in the preceding three years.)

The act increases the limit on business interest deductions to 50% of ATI for the 2019 and 2020 tax years (subject to special partnership rules for 2019). It also allows businesses to calculate their 2020 limit based on their 2019 ATI — an advantage for borrowers whose income declines this year.

Lending limits waived. The act authorized the Office of the Comptroller of the Currency to temporarily waive national bank lending limits. Waivers are permitted until the earlier of December 31, 2020, or termination of the COVID-19 national emergency declaration.

CECL delayed. Most community banks don't need to adopt the current expected credit loss (CECL) methodology of accounting for credit losses until 2023. But for banks otherwise required to apply CECL this year, the act delays implementation to the earlier of December 31, 2020, or termination of the COVID-19 national emergency declaration.

CONSULT YOUR ADVISORS

In this constantly shifting economy, these and other provisions of the CARES Act may be supplemented by regulations and agency guidance — or extended or otherwise modified by additional legislation. So it's a good idea to consult your advisors regularly to ensure that your bank obtains all the relief to which it's entitled. ■

TAKE STEPS NOW TO HANDLE LIQUIDITY RISK

As a result of the COVID-19 pandemic, businesses and banks are suffering under nearly unprecedented economic pressures that are likely to play out for some time. Liquidity risk has been an increasing issue for community banks over the past few years. But in times like these, it's more important than ever for your bank to implement appropriate strategies, policies, procedures and limits to manage and mitigate your liquidity risk. Here are some tips based on guidance from financial institution agencies such as the FDIC.

KNOW THE CAUSES, AND CURES, OF LIQUIDITY RISK

In addition to the recent economic downturn, reasons for the increase in liquidity risk include loan growth accompanied by shrinking liquid asset holdings and increasing reliance on noncore and wholesale sources — such as borrowings, brokered deposits, Internet deposits, deposits obtained through listing services and uninsured deposits — to fund loan growth.

Typically, these alternative funding sources are more expensive and volatile than insured core deposits. And they're subject to legal, regulatory and counterparty requirements that can create liquidity stress, particularly if a bank has credit quality issues or deteriorating capital levels.

The FDIC recognizes that alternative funding sources can be an important component of a well-managed bank's liquidity and funding strategy. But these sources can be problematic if a bank relies on them too heavily. Incorporating a balanced funding strategy into a comprehensive liquidity risk management plan is key to success.

INCORPORATING A BALANCED FUNDING STRATEGY INTO A COMPREHENSIVE LIQUIDITY RISK MANAGEMENT PLAN IS KEY TO SUCCESS.

The FDIC urges banks to consult the federal banking regulators' 2010 *Interagency Policy Statement on Funding and Liquidity Risk Management*, which outlines the essential elements of sound liquidity risk management. Banks should balance the use of alternative funding sources "with prudent capital, earnings and liquidity considerations through the prism of the institution's approved risk tolerance." They should:

- Ensure effective board and management oversight,
- Adopt appropriate strategies, policies, procedures and limits to manage and mitigate liquidity risk,
- Implement appropriate liquidity risk measurement and monitoring systems,
- Actively manage intraday liquidity and collateral,
- Have a diverse mix of existing and potential future funding sources, and
- Hold adequate levels of highly liquid marketable securities that are free of legal, regulatory or operational impediments.

HAVE A CONTINGENCY PLAN

Banks also should design a comprehensive contingency funding plan (CFP) that sufficiently addresses potential adverse liquidity events and emergency cash flow requirements. Finally, they need to set up appropriate internal controls and internal audit processes.

For banks that rely heavily on volatile funding sources, the FDIC emphasizes the need to ensure that the banks' risk tolerances and recovery strategies are reflected in their asset-liability management programs and CFPs. A well-developed CFP should help a bank manage a range of liquidity stress scenarios by establishing clear lines of responsibility and articulating implementation, escalation and communication procedures. It also needs to address triggering mechanisms, early warning indicators and remediation steps that cover the use of contingent funding sources.

CFPs should identify alternative liquidity sources and ensure ready access to contingent funding because, the FDIC explains, "liquidity pressures may spread from one source to another during a significant stress event." Examples of backup funds providers include federal home loan banks, correspondent institutions and others that facilitate repurchase agreements or money market transactions.

An independent party should regularly review and evaluate the various components of a bank's liquidity management process. The review should match the process against regulatory guidance and industry best practices as adjusted for the bank's liquidity risk profile. The reviewer then should report the results to management and the board of directors.

STAY CURRENT

In this rapidly changing and uncertain economic environment, your community bank needs to be especially vigilant about staying ahead of liquidity risk. If you manage to do so, your bank is much more likely to make it through this period unscathed — and even stronger than ever. ■

WILL CECL AFFECT YOUR INCENTIVE COMPENSATION PLANS?

For most community banks, the current expected credit loss (CECL) model doesn't take effect until 2023. Nevertheless, given the impact on banks' financial statements and accounting processes, it's a good idea to start preparing as early as possible. One area that shouldn't be overlooked is CECL's potential impact on incentive compensation plans. For many banks, the model will affect the performance metrics they use to determine compensation, so it's important to consider these effects and adjust your plans accordingly.

WHAT'S CHANGING?

CECL discards today's incurred-loss model, which delays recognition of credit losses until they become "probable," in favor of a forward-looking approach. Under it, banks 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 instruments.

Under the new rules, banks will need to gather and evaluate a much broader range of data than they do currently to estimate expected losses. Banks will need to consider historical and current information, as well as "reasonable and supportable forecasts that affect the collectability of the reported amount." As a result, CECL will cause many banks to increase their allowances for loan and lease losses (ALLL). Although the initial adjustment to the ALLL upon adoption of CECL will run directly through retained earnings, it still may have a negative impact on capital and subsequent earnings.

WHAT'S THE IMPACT ON INCENTIVE COMPENSATION?

Many banks use incentive compensation to attract, retain and motivate management talent in a highly competitive industry. A variety of tools are available to align employees' interests with the bank's financial success, from bonus programs to stock options, restricted stock and other equity-based incentives. The purpose of an incentive compensation plan is to motivate employees to achieve certain results. So for the plan to be effective, it's critical to provide employees with clear, achievable performance targets.

> INCENTIVE COMPENSATION IS EFFECTIVE ONLY IF BASED ON PERFORMANCE METRICS THAT ARE CAREFULLY DESIGNED TO MOTIVATE THE DESIRED EMPLOYEE BEHAVIOR.

Typically, the targets are based on some measure (or combination of measures) of a bank's financial results, such as net income, return on equity or earnings per share. But these measures may be negatively impacted after a bank adopts CECL, reducing performance-based compensation through no fault of the affected employees.

STEPS BANKS SHOULD TAKE

Before implementing CECL, banks should review their incentive compensation plans and determine which performance metrics are likely to be affected.

Depending on the potential impact, banks should consider modifying their plans to ensure that they'll continue providing sufficient motivation to employees. Potential strategies include:

- Adjusting performance targets expected to be negatively affected by CECL,
- Incorporating, or giving additional weight to, metrics on which CECL isn't expected to have a significant impact, such as those tied to gross revenues or productivity,
- Relying more heavily on "relative" metrics that measure the bank's performance compared with its peers, and
- Giving the board more flexibility to adjust compensation awards based on changing circumstances or subjective criteria.

Whichever strategies you explore, be sure to consider how shareholders, regulators and other stakeholders will view them.

WHAT ARE YOUR PLANS?

Incentive compensation is effective only if based on performance metrics that are carefully designed to motivate the desired employee behavior. But even the best-designed plans can become less effective as the business environment, accounting standards or other circumstances change. So it's important to review and evaluate your plans regularly to ensure that they're continuing to work as intended. ■

BANK WIRE

REAL ESTATE TRANSACTIONS AFFECTED BY COVID-19 GET APPRAISAL RELIEF

The federal banking agencies issued an interim final rule (expiring at the end of 2020) that temporarily defers some real-estate-related appraisals and evaluations in response to the COVID-19 national emergency. These appraisals and evaluations can be deferred for up to 120 days after closing of residential or commercial real estate loan transactions. But deferral isn't available for transactions involving real estate acquisition, development or construction. ■

FED RELAXES RESTRICTION ON SAVINGS ACCOUNT TRANSFERS

The Federal Reserve Board issued an interim final rule amending Regulation D (Reserve Requirements of Depository Institutions). The rule deletes the six-per-month limit on "convenient" transfers from the definition of "savings deposit." This change was prompted in part by a desire to provide consumers affected by the COVID-19 pandemic with cash-flow relief. But it also reflects the Board's earlier reduction of the reserve requirement ratio to 0%, rendering it unnecessary to distinguish between reservable "transaction accounts" and non-reservable "savings deposits."

The rule allows (but doesn't require) institutions to suspend enforcement of the limit. Suspension would enable customers to make an unlimited number of transfers or withdrawals from savings accounts. ■

CARES ACT DEFERS PAYROLL TAXES

The Coronavirus Aid, Relief, and Economic Security (CARES) Act allows all employers, including banks, to defer — interest free — the employer's portion of Social Security payroll taxes (6.2%) on wages paid after March 26, 2020, through the end of the year. Half of the deferred amount must be paid by the end of 2021, with the remainder due by the end of 2022.

The deferral doesn't apply to the employee portion of payroll taxes or to the 1.45% Medicare payroll tax. And it's unavailable to employers who obtain loan forgiveness under the Paycheck Protection Program. ■

SURVEY SAYS …

According to the Conference of State Bank Supervisors (CSBS) *2019 National Survey of Community Banks*, more than 35% of respondents said that the cost of funds was the factor most likely to influence profitability (up from 11% just three years earlier), followed by loan demand (32%), operating costs (13%) and loan rates (11%). Interestingly, only 4% of respondents cited regulation as the factor most likely to influence profitability, down from 60% in 2016.

The CSBS survey also asked community bankers to rank the importance of various risks they face. Cybersecurity is viewed as the most important risk faced by community banks, categorized as "very important" by more than 70% of respondents. Other risks viewed as very important by a significant percentage of respondents include credit risk (44.9%), consumer compliance/fair lending risk (23.8%), Bank Secrecy Act risk (22.8%) and market risk (20.2%). ■

acxell ("acxell") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to other firms, acxell provides internal audit, regulatory compliance, BSA/AML, information technology, SOX/FDICIA and enterprise risk management review services and software. acxell 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.

acxell'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 risk management needs, please contact our service coordinators at (877) 651-1700, or log-on to www.acxellrms.com to learn more.*

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