P&G Banking ADVISOR

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P&G Associates

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WHAT'S THE IMPACT OF THE TAX CUTS AND JOBS ACT ON COMMUNITY BANKS?

Last year's tax reform legislation — the Tax Cuts and Jobs Act (TCJA) — represents the most significant overhaul of the Internal Revenue Code in decades. Here's a summary of the provisions that are most relevant to community banks.

CORPORATE TAX RATE REDUCTION

The TCJA lowers the corporate income tax to a flat 21% rate for tax years beginning after December 31, 2017. Previously, the corporate rate was 35% for the highest income bracket, with rates spiking as high as 39% at certain income levels. The act also repeals the corporate alternative minimum tax.

While it's important to note that the TCJA will substantially reduce tax expenses for 2018 and future years, for many banks the act had a negative impact on earnings and regulatory capital for 2017. Why? The sharp reduction in corporate tax rates required these banks to reduce the values of their deferred tax assets at the end of the year.

S CORPORATION BENEFITS

For tax years beginning after December 31, 2017, and before January 1, 2026, the TCJA benefits banks structured as S corporations in two ways: First, it lowers individual income tax rates (the top rate is now 37%, down from 39.6%), thus reducing most owners' taxes on their shares of pass-through income. Second, it allows shareholders (including trusts and estates) to deduct 20% of their qualified business income (QBI) from the bank, subject to certain limitations.

Generally, QBI is a shareholder's distributive share of the bank's net income, excluding certain investment income and reasonable compensation paid to shareholders. The

deduction is generally limited to 50% of W-2 compensation paid by the bank. But this limit doesn't apply to owners with taxable income less than $157,500 ($315,000 for joint filers). Above those income levels, the W-2 wage limitation is phased in over a $50,000 range ($100,000 range for joint filers).

S ELECTION SECOND THOUGHTS

Many community banks operate as S corporations, primarily to avoid the double taxation of C corporation profits: once at the corporate level and a second time when paid out as dividends to shareholders. But now that the gap between individual and corporate tax rates has substantially widened, it may be time to re-evaluate that strategy.

If your bank is currently organized as an S corporation, whether you would benefit by converting to a C corporation depends on your particular circumstances. Factors to consider include:

- Your shareholders' tax brackets,
- The value of the 20% QBI deduction, and
- Your dividend-paying practices.

In general, unless you're contemplating a sale in the foreseeable future that would create substantial capital gains, there's a good chance that converting to a C corporation would be less expensive (particularly if Congress doesn't extend lower individual income tax rates and the 20% QBI deduction after 2025).

LIMITED DEDUCTION FOR INTEREST

The TCJA imposes a new limit on net business interest expense deductibility: For 2018 to 2021, it's generally capped at 30% of "adjusted taxable income," which is similar to earnings before interest, taxes, depreciation and amortization (EBITDA). Beginning in 2022, adjusted taxable income will be similar to earnings before interest and taxes (EBIT).

Disallowed interest expense can be carried forward indefinitely. Businesses, including banks, with average annual gross receipts of $25 million or less are exempt from the new limit and may continue to deduct their interest expense in full. Some other taxpayers are also exempt. For example, some real estate businesses may opt out of the new limit in exchange for less favorable depreciation deductions.

Because the 30% limit applies to *net* interest expense, most banks won't be affected directly. But the limit may have an indirect impact on a bank's lending business — if its borrowers are unable to fully deduct interest payments on their loans.

Banks also might be affected by new limits on mortgage interest deductions. Previously, taxpayers could deduct interest on up to $1 million in acquisition debt on a first or second residence, plus up to $100,000 in home equity debt. For 2018 through 2025, the TCJA reduces the first limit to $750,000 (though it grandfathers in acquisition debt that originated before December 15, 2017) and eliminates the home equity interest deduction (though such interest might still be deductible in certain instances, depending on how the borrowed funds are used).

WHAT *HASN'T* CHANGED?

The Tax Cuts and Jobs Act also is noteworthy for what it *didn't* change. Key proposals that didn't make it into the final bill include:

Deferred compensation. Many community banks use nonqualified deferred compensation plans to enhance key employees' retirement benefits. A provision that would have effectively eliminated the benefits of these plans was excluded from the final bill.

Bond interest. The House bill would have repealed the tax exemption for newly issued private activity bonds, but the final bill preserves the exemption.

In addition, despite intensive lobbying by community banking industry groups, the act preserves the tax exemption for credit unions and Farm Credit System lenders. But, fortunately for community banks, lower tax rates weaken the competitive advantage that these tax exemptions provide to credit unions and Farm Credit System lenders.

PHASED-OUT DEDUCTION FOR FDIC PREMIUMS

The TCJA phases out the FDIC premium deduction for banks with total consolidated assets between $10 billion and $50 billion — and eliminates the deduction for banks with assets of $50 billion or more. Banks with less than $10 billion in assets may continue to fully deduct FDIC premiums, however, so most community banks won't be affected.

TCJA IMPACTS

These and other provisions of the TCJA will affect community banks — either directly or indirectly. Your tax advisors can help you determine the act's impact on your tax-planning efforts. ■

ENOUGH VS. TOO MUCH

Help borrowers understand their working capital needs

Your borrowers need to manage their working capital in a way that allows them to maintain stability while enabling them to seek new profit-making opportunities. This means they need to understand how various aspects of their operations, such as accounts payable, help or hinder working capital maintenance.

ENCOURAGING EFFECTIVE STRATEGIES

An ample amount of working capital allows assets to be converted to cash quickly, enabling your borrowers to cover current obligations. But too much cash tied up in working capital can prevent borrowers from taking positive courses of action that will help grow the business, such as expanding to new markets or investing in equipment.

Excessive cash balances also can encourage borrowers' management to become complacent about working capital. If they have plenty of money in the checkbook, they might be less hungry to collect receivables and less disciplined when ordering inventory.

When cash is generated through debt, rather than improved operating cash flow, there could be even bigger problems. In such situations, borrowers need to earn a higher return on their investments than they're paying in interest. But those that employ sloppy working capital practices are unlikely to achieve adequate returns. Eventually, debt and interest payments can overwhelm borrowers.

Thanks to reduced interest rates on new debt and higher revenues, some borrowers are stockpiling cash. You might notice that a borrower's working capital has increased over the last few years or is significantly higher than that of its competitors. Proactive lenders point out the trend and encourage effective collection and inventory management strategies.

ADVISING ON COLLECTIONS AND ACCOUNTS RECEIVABLE

When a borrower sells on credit, it finances its customers' operations. Stale receivables — typically any balance over 45 or 60 days outstanding, depending on the industry — are a red flag.

Getting a handle on receivables starts by honestly evaluating which items should be written off as bad debts. Then viable balances need to be "talked in the door" as soon as possible. Enhanced collection efforts might include early bird discounts, electronic invoices and collection-based sales compensation programs.

Dedicated collection staff should be charged with approving and monitoring customer credit, sending out collection letters, and making phone calls for any invoices more than 30 days late. Consequently, they should be among your borrowers' most dedicated employees.

Alternatively, some borrowers sell or "factor" receivables to a third party at a discount, typically 20% to 30% off the invoice amount.

SUGGESTING INVENTORY SOLUTIONS

Inventory is a huge investment for manufacturers, distributors, retailers and contractors. It's also difficult to track and value. Enhanced forecasting and data sharing with suppliers can reduce the need for safety stock and result in smarter ordering practices.

Computerized technology — such as bar codes, radio frequency identification and enterprise resource planning tools — also improves inventory tracking and ordering practices. These solutions often come with a hefty price tag, but not always.

Handheld replenishment devices are a simple solution manufacturers use to improve line productivity and lower their investment in work-in-progress inventory. Here, line workers press replenishment buttons on wireless devices when they need more materials at their station. This signals a refill request to the forklift driver, who then immediately replenishes the worker's supply.

SUPPORTING YOUR BORROWERS WITH INFORMATION

It's important to carefully evaluate the soundness of potential borrowers' working capital management methods. To best assist borrowers, become familiar with the latest capital management strategies and practices. Taking an active role in offering advice can help ensure your borrowers remain good credit risks over the long term. ■

RECOGNIZING THE WARNING SIGNS FOR LIQUIDITY RISK

Risk management is a critical function at community banks. And while interest rate risk gets the lion's share of attention, banks shouldn't overlook liquidity risk. According to regulatory reports, liquidity risk has been increasing in recent years for "smaller" banks (those with assets under $10 billion).

WHY THE INCREASE?

Reasons for this trend 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. An article in the Summer 2017 issue of the FDIC's *Supervisory Insights* mentions that "rapid asset growth funded by brokered deposits has been directly associated with a higher incidence of problem banks and failures."

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.

WHAT'S THE PLAN?

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.

> AN INDEPENDENT PARTY SHOULD REGULARLY REVIEW AND EVALUATE THE VARIOUS COMPONENTS OF A BANK'S LIQUIDITY MANAGEMENT PROCESS.

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:

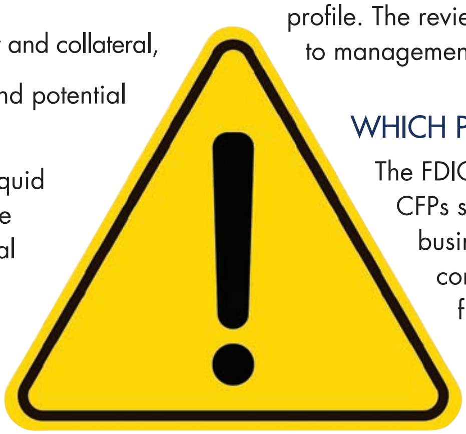
- Ensure effective board and management oversight,
- Adopt appropriate strategies, policies, procedures and limits to manage and mitigate liquidity risk,
- Implement appropriate liquidity risk measurement and monitoring systems,
- Actively manage intraday liquidity and collateral,
- Have a diverse mix 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.

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.



WHICH PLAN IS THE BEST FIT?

The FDIC emphasizes that community bank CFPs should be customized to fit a bank's business lines and risk profile. More complex institutions should use cash flow forecasting and stress testing to ensure they maintain a sufficient liquid asset cushion to absorb potential risks. ■

BANK WIRE

DOT-BANK DOMAIN NAME OFFERS IMPROVED SECURITY

Most banks use the dot-com extension at the ends of their website addresses, also known as the top-level domain (TLD). But the dot-bank TLD offers several advantages, including enhanced security, which is of critical importance to banking customers today.

Eligibility for the dot-bank TLD, available since 2015, is limited to qualified applicants — including banks and savings associations chartered and supervised by state or national regulators, trade groups and other banking industry associations, service providers principally owned or supported by regulated entities, and certain government banking regulators and their associations. In addition, successful applicants must pass a screening process and implement various technologies and processes that help guard banking customers against fraud.

For more information, see register.bank/faq. ■

HMDA GUIDANCE HELPS AVOID PENALTIES

Since January 1, 2018, banks have been required to submit Home Mortgage Disclosure Act (HMDA) data using the Consumer Financial Protection Bureau's (CFPB's) new online platform. Late last year, the CFPB announced that it wouldn't impose penalties for errors in HMDA data collected in 2018 and reported in 2019. And it wouldn't require banks to resubmit such data unless the errors are material.

On August 23, 2017, the Federal Financial Institutions Examination Council issued guidelines for examiners to use in assessing the accuracy of HMDA data that institutions record and report. The guidelines — which describe procedures for sampling and validating HMDA data — provide banks with insight into how examiners will assess HMDA data. To read them, visit fdic.gov and type "FIL 2017-36" in the search box. ■

AWARENESS OF EMAIL WIRE TRANSFER SCHEMES PREVENTS FRAUD

A Financial Crimes Enforcement Network (FinCEN) advisory warns banks about the dangers of email compromise fraud schemes involving wire transfers. According to the advisory, from 2013 to late 2016 there were approximately 22,000 reported cases of such fraud, involving $3.1 billion. In a typical scheme, a cybercriminal uses compromised email accounts to impersonate customers and mislead financial institutions into conducting seemingly legitimate — but unauthorized — wire transfers.

The advisory lists several red flags banks should look for when reviewing emailed wire transfer instructions. They should follow up with additional review and verification if, among other things:

- The instructions contain different language, timing and amounts than previously verified instructions,
- The customer's email address is slightly different from a known customer's address (for example, john_doe@abc.com instead of john-doe@abc.com),
- The instructions direct payment to a known beneficiary, but the beneficiary's account information is different from what was previously used,
- The instructions describe the transaction as "urgent," "secret," or "confidential," or
- The instructions originate from a customer's employee who is newly authorized on the account or who has never sent wire transfer instructions before.

To read the full advisory, visit fincen.gov and type FIN-2016-A003 in the search box. ■

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.

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