acxell ADVISOR

Spring 2020

SHOULD YOU BE STRESS TESTING YOUR BORROWERS?

BREAKING UP IS HARD TO DO
Protect bank interests after a divorce

ARTIFICIAL INTELLIGENCE MAY BE THE FUTURE OF COMMUNITY BANKING

BANK WIRE

acxell

www.acxellrms.com 877.651.1700

SHOULD YOU BE STRESS TESTING YOUR BORROWERS?

Most banks are familiar with the concept of stress testing: By evaluating the impact of adverse external events on a bank's earnings, capital adequacy and other financial measures, stress testing can be a highly effective risk management tool. And while community banks generally aren't required to conduct stress testing, banking regulators view it as a best practice.

For example, Office of the Comptroller of the Currency (OCC) guidance considers "some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis to be a key part of sound risk management for community banks." Stress testing is often performed at the enterprise, or portfolio, level. However, testing at the individual loan level — beginning during the underwriting process — can be a powerful technique for revealing hidden risks.

TWO APPROACHES, FOUR METHODS

Stress testing generally involves scenario analysis. This consists of applying historical or hypothetical scenarios to predict the financial impact of various events, such as a severe recession, loss of a major client or a localized economic downturn. Tools for performing such tests can range from simple spreadsheet programs to sophisticated computer models.

The OCC's guidance doesn't prescribe any particular methods of stress testing. It describes two basic approaches to stress testing: "bottom up" and "top down." A bottom-up approach generally involves conducting stress tests at the individual loan level and aggregating the results. In contrast, a top-down approach applies estimated stress loss rates under various scenarios to pools of loans with similar risk characteristics.

The guidance outlines four methods to consider:

1. Transaction level stress testing. This estimates potential losses at the loan level by assessing the impact of changing economic conditions on a borrower's ability to service debt.

2. Portfolio level stress testing. This method helps identify current and emerging loan portfolio risks and vulnerabilities (and their potential impact on earnings and capital) by assessing the impact of changing economic conditions on borrower performance, identifying credit concentrations and gauging the resulting change in overall portfolio credit quality.

3. Enterprisewide stress testing. This considers various types of risk — such as credit risk within loan and security portfolios, counterparty credit risk, interest rate risk and liquidity risk — and their interrelated

CANADA'S MORTGAGE STRESS-TESTING LAW

Canada takes an interesting approach to evaluating mortgage loans. Under a law that took effect in 2018, federally regulated banks are required to "stress test" all mortgage applicants. To pass the stress test, an applicant must qualify for a loan at the contractual interest rate plus 2% or at the Bank of Canada's five-year benchmark rate (5.19% at press time), whichever is higher. So, for example, a borrower applying for a 3.75% mortgage would have to qualify for a mortgage at 5.75%. The rule doesn't apply to borrowers who are renewing a mortgage with the same lender.

The idea behind the law is that requiring borrowers to qualify at a higher rate than they're actually paying prevents them from overextending themselves. And since the law took effect, delinquency rates are down. But the law is also controversial because, among other things, it reduces purchasing power for many home-buyers and the benchmark rate is susceptible to manipulation by the largest banks.

effects on the overall financial impact under a given economic scenario.

4. Reverse stress testing. This approach assumes a specific adverse outcome, such as credit losses severe enough to result in failure to meet regulatory capital ratios. It then works backward to deduce the types of events that could produce such an outcome.

> TOOLS FOR PERFORMING STRESS TESTS CAN RANGE FROM SIMPLE SPREADSHEET PROGRAMS TO SOPHISTICATED COMPUTER MODELS.

The right approach and method for a particular bank depends on its portfolio risk and complexity, as well as its resources. Even a simple stress-testing approach can produce positive results. (See "Canada's mortgage stress-testing law" above.)

STRESS TESTING AND THE UNDERWRITING PROCESS

A bottom-up approach at the transaction level may offer a significant advantage: In addition to assessing the potential impact of various scenarios on a bank's earnings and capital, it can, according to the OCC, help the bank "gauge a borrower's vulnerability to default and loss, foster early problem loan identification and strategic decision making, and strengthen strategic decisions about key loans."

For example, when evaluating a loan application, consider gathering information on the various risks the borrower faces — including operational, financial, compliance, strategic and reputational risks. This information can be used to run stress tests that measure the potential impact of various risk-related scenarios on the borrower's ability to pay. An added benefit of this process is that, by discussing identified risks and stress test results with borrowers, you can help them understand their risks and develop strategies for managing and mitigating them, such as tightening internal controls, developing business continuity / disaster recovery plans or purchasing insurance.

A POWERFUL TOOL

Stress testing is an important part of a community bank's risk management process. It can also be a powerful tool for evaluating loan applications and revealing hidden vulnerabilities that may jeopardize potential borrowers' ability to pay down the road. ■

BREAKING UP IS HARD TO DO

Protect bank interests after a divorce

Privately owned family businesses typically make up a significant portion of community banks' loan portfolios. Often, such businesses are co-owned by two partners — who are also married. If the marriage falls apart, will the business follow suit? There are several factors to be aware of if your bank's loans are at risk due to divorce.

CONTROL AND GOODWILL MATTER

Sometimes one spouse controls the business, and the other spouse pursues outside interests. A key question in these cases is how much of the private business interest to include in the marital estate. The answer is a function of purchase date, prenuptial agreements, length of marriage, legal precedent and state law.

Goodwill is another point of contention. If a business has value beyond its tangible net worth, how is intangible "goodwill" split up? All goodwill is included in (or excluded from) the marital estate in some states. But about half the states divide goodwill into two pieces: business goodwill and personal goodwill. The latter is excluded from value in these states.

Accurate valuations and reasonable payout periods are important. Settlements that disproportionately favor the noncontrolling spouse can drain company resources and cause financial distress. If the parties can't reach an equitable settlement, it's also possible for the court to mandate a liquidation, which threatens business continuity.

When the company buys out a spouse, Treasury stock might appear on the customer's balance sheet. Or you might see an increase in shareholder loans if the owner-spouse borrows money from the business to pay divorce settlement obligations.

AVOIDANCE STRATEGIES CAN BACKFIRE

The noncontrolling (or nonmonied) spouse also may receive alimony and child support from the controlling shareholder. Maintenance payments typically are based on the owner's annual salary, bonus and perks.

Unscrupulous owner-spouses may try to change compensation levels in anticipation of divorce. Depending on the type of entity they own, a lower wage level may benefit them in negotiations for spousal maintenance and child support.

Also be aware that what divorcing borrowers say about unreported revenues, below-market compensation and personal expenses run through the business could lead to negative tax consequences. Publicly admitting these tax avoidance strategies puts both spouses *and* the business at risk for IRS inquiry, which could lead to difficulties repaying the loan.

BUYOUT PLANS CAN PREVENT DISSOLUTION

Many private businesses are run by both spouses, whose complementary skill sets make for a hard decision: Who's going to run the business after the

divorce? In limited cases, the spouses may want to continue to run the business together. Like most stakeholders, if co-owners decide to split up personally, but maintain their professional relationships and continue co-managing the business, you may be rightfully skeptical about their future business relationship. Usually, however, the parties can't imagine working with each other. Such a scenario requires a buyout and a noncompete agreement.

Buyouts should occur over a reasonable time period and can include an earnout — wherein a portion of the selling price is contingent on future earnings — to avoid undue strain on the business. Future success is uncertain when a business loses a key person. It's fair for both shareholders to bear that risk. If they don't, the remaining owner, and your bank, could be at risk.

Even if your ma-and-pa business borrowers aren't currently contemplating divorce, consider what might happen if they did. Proactive family businesses have a buy-sell agreement in place *before* personal relationships sour. Factors to consider include valuation formulas and methods, valuation discounts, earnout schedules, postbuyout consulting contracts, noncompete agreements and payment of appraisal fees.

STAYING ENGAGED WITH BORROWERS IS KEY

Keeping your bank's loans stable and profitable requires you to stay aware of many issues that might crop up for your borrowers over time — including divorce. If you stay on top of potential problems, you're likely to be able to help your borrowers navigate these difficult waters and come out relatively unscathed, protecting your loans in the process. ■

ARTIFICIAL INTELLIGENCE MAY BE THE FUTURE OF COMMUNITY BANKING

Recent technological developments — such as artificial intelligence (AI), robotic process automation (RPA) and machine learning — are rapidly changing the way we do business. And the banking industry is no exception. Although large banks were the first to embrace these technologies, an increasing number of community banks are now recognizing their value. It may be some time before smaller banks can afford these technologies, but their potential benefits shouldn't be ignored.

ENHANCE RELATIONSHIPS

At first glance, AI and automation may seem inconsistent with the personalized attention most community banks rely on to distinguish themselves from their larger competitors. But in fact, these technologies

enhance a community bank's ability to personalize a customer's experience.

Of course, technology can't replace human judgment, but by automating and streamlining routine tasks, it can free up staff to focus on what they do best: onboarding new customers, developing personal relationships with current customers, and educating all customers about products, services and promotional opportunities.

TAKE ADVANTAGE OF NEW TECHNOLOGIES

The potential uses for AI, RPA and other new technologies are virtually limitless. For instance, community banks can use these technologies to:

Open accounts. Some banks are using RPA to automate the account opening process and even accept loan applications. It may take a staff person only five or 10 minutes to open an account. But when you consider the many thousands — or tens of thousands — of accounts opened every year, automating the process can save a significant amount of staff time. Plus, automated systems can help ensure all required information is collected.

Change addresses and other information. Typically, when a customer calls a bank to change his or her address or other information, an employee must go through multiple computer screens in the bank's system to process the change. With RPA, once the initial information is input, the system can complete the remaining steps automatically, saving time for both customers and bank staff.

Detect BSA/AML crimes. Banks can use AI and machine learning to support their Bank Secrecy Act (BSA) and anti-money laundering (AML) compliance efforts. For example, these technologies can sift through enormous amounts of transaction data and identify suspicious behavioral patterns that would be virtually impossible for humans to detect. And by minimizing the number of false positives and negatives, they can help ensure that investigators focus on truly suspicious activities rather than legitimate transactions.

Improve cybersecurity and fraud protection. The ability of AI to mine huge amounts of data and quickly spot anomalies makes it a powerful fraud detection tool. It's particularly effective when it comes to cybersecurity. A bank's IT department may receive hundreds of thousands, or even millions, of cyber threat alerts every month — too many to investigate effectively. AI can comb through this information and alert the bank to potential threats that require immediate attention.

MIND THE DATA GAP

As advanced technologies become more commonplace, one of the biggest challenges for community banks will be to ensure they have sufficient data to use these technologies effectively. To do their jobs, AI and machine learning require large amounts of data from which to learn and train. For large institutions with millions of customers, this generally isn't an obstacle — but many community banks lack the data they need to ensure these technology solutions are effective and accurate.

To prepare to take advantage of the many benefits offered by AI and machine learning, banks should start by taking inventory of their own data. If necessary, banks can supplement this data through data-sharing arrangements or by purchasing data from third parties. A relatively new technique that shows promise is "synthetic data," which is generated by applying algorithms to a bank's existing data.

READY FOR PRIME TIME?

AI and automation have great potential, but it may be some time before community banks fully embrace the technology, which is expensive to implement and maintain. In addition, there may be significant costs associated with gathering the data needed to run it effectively. Nevertheless, it's important for community banks to monitor developments in this area and consider how these technologies might improve their businesses down the road. ■

BANK WIRE

HEIGHTENED CYBERSECURITY RISK CONCERNS

The OCC and FDIC recently issued an interagency statement on heightened cybersecurity risks, prompted in part by a warning from the Department of Homeland Security of potential cyberattacks against U.S. targets because of increased geopolitical tension. The statement reminds banks not only to implement and maintain effective preventive controls, but also to prepare for a worst-case scenario by maintaining sufficient business continuity planning processes for the rapid recovery, resumption and maintenance of the institution's operations.

The statement describes six key cybersecurity controls that are critical to protecting banks from malicious activity:

1. Response, resilience and recovery capabilities,
2. Identity and access management,
3. Network configuration and system hardening (that is, modifying settings and eliminating unnecessary programs to minimize security risks),
4. Employee training,
5. Security tools and monitoring, and
6. Data protection.

For a detailed discussion of these controls, you can read the statement by visiting fdic.gov and searching for Financial Institution Letter FIL-3-2020. (Type "FIL-3-2020.") ■

OCC ANNUAL REPORT EMPHASIZES BSA/AML RISK

The OCC recently issued its 2019 Annual Report. The report warned that compliance risk related to Bank Secrecy Act/anti-money laundering activities remained high last year. It encouraged banks to implement BSA/AML risk management systems commensurate with the risk associated with their products, services, customers and geographic footprint. Noting that BSA/AML compliance remains a priority, the OCC outlined recent guidance that embraces using innovative technologies to meet these compliance obligations. The agency also encourages community banks with lower BSA risk profiles to reduce costs and increase operational efficiency by sharing BSA compliance-related resources. ■

DEBT COLLECTION: HANDLE WITH CARE

A recent federal court case, *Hackler v. Tolteca Enterprises Inc.*, illustrates the importance of carefully following the Fair Debt Collection Practices Act (FDCPA). In that case, a collection agency sent a letter to a debtor attempting to collect a debt. It stated, "If you dispute the validity of this debt within 30 days, from receipt of this notice, we will mail verification of the debt to you. If you do not dispute the validity of this debt within 30 days, from receipt of this notice, we will assume it is valid. At your request, we will provide you with the name and address of the original creditor if different from the current creditor."

Because the letter failed to specify that the debt must be disputed, and the request must be made "in writing," as required under the statutory notice requirements, the U.S. District Court for the Western District of Texas found the defendant liable for violations of the FDCPA. ■

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. ©2020

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.acxellrms.com

Headquarters:
646 US Highway 18
East Brunswick, NJ 08816

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