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New lease accounting rules

WHAT WILL BE THE IMPACT?

After 10 years of deliberations, the Financial Accounting Standards Board (FASB) has finally issued its new lease accounting rules with the publication of Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*. Banks should evaluate the ASU's impact on both their loan customers and their own balance sheets and regulatory capital.

For public companies, the new rules apply to fiscal years starting after December 15, 2018 (including interim periods within those years). Nonpublic companies have until fiscal years starting after December 15, 2019 (and for interim periods in fiscal years starting after that date in 2020).

OFF-BALANCE-SHEET LEASES ARE HISTORY

Currently, under Generally Accepted Accounting Principles (GAAP), leases are classified either as "capital" or "operating." Generally, a capital lease transfers ownership of leased assets to the lessee, while an operating lease transfers only the "right-of-use" leased assets during the lease term.

Under GAAP, capital leases are reported on an organization's balance sheet, but operating leases aren't (although footnote disclosures are required). Today, most leases are off-balance-sheet leases. The FASB believes this practice makes it difficult for financial statement users to compare organizations that own their productive assets with organizations that lease them.

The new rules classify leases either as "finance" leases (similar to capital leases) or operating leases. And *all* leases with terms that exceed 12 months will be reported on the balance sheet. In other words, with the exception of short-term leases, off-balance-sheet treatment will be passé.

Initially, organizations will treat leases similarly to capital leases, recording a right-of-use asset and a lease liability. Both are based on the present value of minimum payments under the lease.

Expense recognition will depend on how a lease is classified. For finance leases, organizations will amortize the right-of-use asset, generally on a straight-line basis, and recognize interest expense and liability repayment over the life of the lease, much as they would with a loan. This means they'll recognize higher expenses early in a lease's life and lower expenses later on. For operating leases, organizations will recognize lease expenses on a straight-line basis (subject to certain adjustments).

MAKING THE TRANSITION

The effective date of the Financial Accounting Standards Board's new lease accounting rules may seem far away, but there's less time to prepare than you might think. Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, requires a "modified retrospective" transition.

That means organizations must apply the new rules at the beginning of the earliest comparative period presented on their financial statements for the adoption year. In other words, organizations that present one or two years of comparative financial information must implement appropriate reporting systems and processes well in advance of the effective date.

To ease the burden of this transition, the ASU allows organizations to elect certain "practical expedients." Essentially, these elections allow organizations to account for existing leases using current Generally Accepted Accounting Principles (GAAP), unless those leases are modified. However, they must record a right-to-use asset and lease liability for operating leases based on the present value (at each reporting date) of the remaining minimum lease payments tracked and disclosed under current GAAP.

EFFECT ON BORROWERS

When the new rules take effect, loan customers with significant operating leases will experience an immediate balance sheet increase in assets and liabilities. The FASB has stated it believes lease liabilities resulting from operating leases should be classified as operating liabilities rather than debt.

Absent alterations to loan covenant details defining these as operating liabilities rather than debt, this could cause some customers to appear to be in violation of loan covenants that place limits on their overall debt or require them to maintain a certain debt-to-equity ratio. The impact on specific borrowers will depend on their particular circumstances and the language of their loan agreements (especially the definition of "debt").

Bankers should review existing loan covenants and consider modifications to avoid unnecessary breaches. Keep in mind that the new rules simply change the way operating leases are reported — they have no bearing on a borrower's creditworthiness or ability to repay.

As you review existing loans and negotiate new ones, consider developing new covenant models that provide sufficient cushion to withstand upcoming lease accounting changes. Alternatively, you might incorporate one covenant model now and another when the lease accounting changes take effect. Consult with your CPA regarding other options.

RAMIFICATIONS FOR BANKS

For banks that lease their facilities, equipment or other fixed assets, the new lease accounting rules may have a significant impact on their own balance sheets. It's still unclear how this will affect their regulatory capital calculations. One possibility: Some banks will be required to report a more highly leveraged borrower base, which could alter their risk-weighted asset mix. To avoid unpleasant surprises, banks should analyze the potential impact of the new rules well before they take effect.

The new rules also may require banks to modify management compensation plans based on performance-based metrics.

NO TIME TO LOSE

Although the effective date is a few years off, banks should begin preparing soon. Not only do the new rules affect current loan negotiations, but the ASU's transition approach (see "Making the transition" above) may require banks to implement changes before the rules take effect. ■

GETTING THE FAMILY BUSINESS READY FOR SUCCESSION

With Baby Boomers in the United States still retiring in droves, your bank's lending department should be encouraging these borrowers to have a succession plan for their business in place. Such a plan can't be drafted overnight, and the sooner one is developed, the better prepared the company will be for a leadership transition.

WHO'LL BE NEXT?

The key operational issue addressed in any succession plan is: Who will one day lead the enterprise? For family-owned businesses, finding a successor can be difficult. Children or other relatives may be qualified but have no interest in taking the reins. Or they may want to be involved but not have sufficient experience.

To deal with issues such as these, a family business owner must take time to identify and nurture future leaders. Early on, the owner needs to select someone who he or she believes holds leadership potential and then expose the prospective successor to all aspects of running the business. When control formally transfers, this will allow the new leader to truly be seen as the "boss" and be fully capable of making big decisions. It will also minimize surprises and animosity among candidates who aren't chosen to take the lead.

The current owner needs to provide a well-defined path for the successor and assurance that his or her hard work during the transition period will eventually be rewarded with the leadership role as well as ownership interests. Ideally, the owner also will set a specific timeframe for the transfer of control and ownership to officially occur.

Most family business owners have more than one heir to factor into the succession planning equation. So,

it's important to involve the *entire* family, whether or not they're all active in the business, in the planning process. This enables everyone to understand their roles — and the financial and personal consequences of an unsuccessful succession plan.

A common issue is how to equitably divide assets among heirs when only some of them will have control of or receive ownership interests in the business. If there are sufficient liquid assets, the owner can purchase life insurance to provide for any children who won't be involved in the business and give ownership interests only to those who *will* be involved. Or the owner might establish a family trust to own and operate the business, so that the entire family shares the risks and benefits.

WHAT'S THE PLAN?

No matter who's the chosen successor, the family business owner will need to put together a team of professionals — including a lender, an accountant, a lawyer and an insurance advisor — to guide the succession-planning process. These experts can help the owner create a plan that accomplishes a variety of important goals.

For starters, the business will need to create a management structure that will survive the current owner's departure. The business should also be on sound financial footing to ensure adequate liquidity to fund the owner's retirement or a buyout. A buy-sell agreement is also critical in restricting transfers of ownership interests. Last, but certainly not least, the owner should consider income and estate tax issues.

EVERYONE SHOULD THINK IT THROUGH

And what if your borrower isn't a family business and the principal isn't a Baby Boomer? This doesn't matter — all businesses should have a succession plan in place. The company leader not only will retire someday, but that person also could die suddenly or be unable to continue on in a leadership capacity, for whatever reason.

As in a family business, a logical successor to take over the company should be pinpointed. And if the new leader will come from *inside* the business, a plan to prepare that person for his or her new role should be in place. ■

TIPS FOR BUILDING CUSTOMER LOYALTY

In this high-tech age, here are 3 ways to boost retention

For community banks, customer loyalty is one of the keys to profitability. But with the advent of online banking and mobile technology, banking products and services are becoming increasingly commoditized. To build customer loyalty, community banks should focus on their strengths — the things that set them apart from other banks, like personalized customer service and community ties. Here are three strategies to consider.

1. CONDUCT A CORE DEPOSIT STUDY

A good first step is to identify your core deposits and develop an understanding of customer behaviors. Which depositors are loyal, long-term customers? Which depositors are motivated primarily by interest rates? A core deposit study can help you distinguish between the two and predict the impact of fluctuating interest rates on customer retention. Banking regulators have been strongly encouraging banks to conduct these studies as part of their overall asset-liability management efforts.

Core deposit studies assess how much of your bank's deposit base is truly interest rate sensitive by examining past depositor behavior. They also look at factors that tend to predict depositor longevity. For example, customers with multiple banking products (such as checking and savings accounts, mortgages and auto loans) and higher average deposit balances are less likely to switch banks.

2. ENGAGE EMPLOYEES TO ENGAGE CUSTOMERS

To build customer loyalty, it's critical to ensure that customers are engaged. According to research by Gallup, engaged customers are more loyal, are more likely to recommend the bank to family and friends, and represent a bigger "share of wallet" (that is, the percentage of a customer's banking business captured by the bank).

> AN INCREASING NUMBER OF CUSTOMERS, MILLENNIALS IN PARTICULAR, USE MULTIPLE CHANNELS AND DEVICES TO INTERACT WITH THEIR BANKS.

Gallup's most recent retail banking study shows that approximately 36% of customers at community banks and small regional banks (less than $40 billion in deposits) are actively engaged, compared to 27% at large regional banks (over $90 billion in deposits) and only 17% at nationwide banks (over $500 billion in deposits). That's the good news. The bad news is that 50% of customers at online-only banks are fully engaged.

So, how can community banks do a better job of engaging their customers in order to compete with online banks? According to the pollsters, the answer lies in leveraging their "local touch" by knowing their

customers, delivering superior service, and providing customized solutions and advice. And to do that, the company says, banks must ensure that their front-line employees — tellers, loan officers, branch managers and call center representatives — are fully engaged in their jobs.

Engaging employees has little to do with competitive salaries and benefits. Rather, it means providing employees with opportunities for challenging work, responsibility, recognition and personal growth.

3. INVEST IN TECHNOLOGY

An increasing number of customers — Millennials in particular — use multiple channels and devices to interact with their banks. These include online banking, mobile banking applications and two-way texting. To build loyalty, banks should enable customers to use their preferred channels and ensure that their experiences across channels are seamless. And don't overlook the importance of social media platforms, such as Facebook and Twitter. Younger customers are more likely to use these platforms to recommend your bank to their friends and families.

LOYALTY PAYS

According to Gallup, in the retail banking industry fully engaged customers bring in 37% more revenue than those who are "actively disengaged." Banks that take steps to build customer loyalty can reap significant rewards. ■

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CFPB BRINGS FIRST DATA SECURITY ENFORCEMENT ACTION

The Consumer Financial Protection Bureau (CFPB) recently brought its first-ever enforcement action in a data security matter. It alleged that online payment platform Dwolla, Inc., deceived consumers about its data security practices and the safety of its system. Among other things, the CFPB asserted that the company falsely claimed its "information is securely encrypted and stored," even though some sensitive consumer personal information wasn't in fact encrypted. The company also allegedly released applications to the public before testing whether they were secure.

The CFPB issued a consent order requiring Dwolla to pay a $100,000 penalty and fix its security practices. Notably, the company hadn't actually experienced a breach. The CFPB said it brought the action under the Dodd-Frank Act, to protect consumers against "unfair, deceptive or abusive acts or practices." ■

OCC CRACKING DOWN ON BSA/AML VIOLATIONS

Recently, the Office of the Comptroller of the Currency (OCC) signaled its intent to be more aggressive in enforcing Bank Secrecy Act / Anti-Money Laundering (BSA/AML) regulations. In addition to issuing a bulletin highlighting the consequences of noncompliance, the OCC has published revised guidelines for calculating penalties against banks that violate BSA/AML rules.

And the OCC, together with other federal regulators, has imposed $6.5 million in civil money penalties against a $1.57 billion Florida bank for persistent BSA/AML deficiencies. ■

OVERDRAFT POLICIES IN THE SPOTLIGHT

Banks should review and evaluate their overdraft policies in anticipation of CFPB regulatory activity in this area. Recent CFPB publications and speeches show an increased focus on banks' overdraft products and practices. For example, CFPB director Richard Cordray has urged financial institutions to offer lower-risk accounts that can't produce a negative balance. The CFPB hasn't indicated when such regulations might be announced. ■

IS YOUR BANK A CANDIDATE FOR A QUASI-REORGANIZATION?

If your bank has an accumulated deficit — that is, if it has negative cumulative retained earnings — regulatory restrictions may prevent it from paying dividends to its shareholders or holding company, even if it has substantial surplus capital accounts. One potential solution is a "quasi-reorganization," which is available to national banks as well as to banks in states whose laws allow it.

Essentially, a quasi-reorganization allows a bank to transfer funds from its capital and surplus accounts into its undivided profits account, eliminating the deficit and giving the bank a fresh start. From that point on, earnings can be used for dividends, subject to applicable regulations and safety and soundness considerations.

To conduct a quasi-reorganization, eligible banks must satisfy a number of requirements, including obtaining regulatory approval. ■

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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.

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