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HOW CAN FINANCIAL DUE DILIGENCE SUPPORT YOUR LOANS?

DON'T TAKE GOVERNMENT GUARANTEES FOR GRANTED
How to avoid jeopardizing your SBA loan guarantees

BANK WIRE

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IN THE WAKE OF BANK FAILURES, EXPECT INCREASED SCRUTINY FROM REGULATORS

The failures of Silicon Valley Bank (SVB) and Signature Bank and the self-liquidation of Silvergate Bank in March 2023 served as wake-up calls for banking regulators and lawmakers. Although industry experts agree that steps must be taken to avoid similar failures in the future, they disagree over whether the solution is to implement stricter banking regulations or simply to improve oversight under existing regulations. Whatever the answer, banks can expect regulators to watch them more closely, particularly regarding capital, liquidity and interest rate risks.

WHAT'S YOUR LEVEL OF RISK?

The good news for community banks is that their approach to banking is typically different than the niche banks that recently failed. So they're generally not as susceptible to the types of risks to which those banks were exposed. For example, all three banks that failed had high percentages of uninsured deposits and dangerously high deposit concentrations. (Silvergate and Signature were heavily concentrated in cryptocurrency, and SVB's deposit base was largely made up of uninsured tech start-up venture capital.)

Nevertheless, community banks should review their deposit mixes. They need to evaluate their risk management policies and procedures to prepare for heightened regulatory scrutiny.

WHAT HAPPENED?

Major contributors to recent bank failures included the rapid increase in interest rates during 2022 and early 2023, as well as the collapse of the FTX crypto exchange. Rising interest rates exposed dormant interest rate risks at many banks that had invested heavily in long-term assets in a quest for higher yields when interest rates had reached rock bottom. As interest rates increased, the value of these banks' bond portfolios plummeted, resulting in significant unrealized losses.

As FDIC Chair Martin Gruenberg explained in a statement to the Senate Banking Committee, "When Silvergate Bank and SVB experienced rapidly accelerating liquidity demands, they sold securities at a loss. The now realized losses created both liquidity and capital risk for those firms, resulting in a self-liquidation and failure." SVB, for example, announced that

COMMUNICATION IS KEY FOR COMMUNITY BANKS

Recent bank failures have created fear among many depositors, so it's critical for banks to assure them that their money is safe. For community banks, that means educating customers about how their approach to banking differentiates them from the institutions that collapsed in March. They should emphasize their commitments to managing liquidity and interest rate risk and maintaining a diverse deposit base from the communities they serve — rather than concentrating deposits in risky industries or customer segments. Community banks also tend to have low percentages of uninsured deposits.

Now is also a good time to remind customers of the other advantages that community banks have over their larger competitors. Examples include their ability to offer face-to-face engagement and personalized services.

it was raising capital and sold $21 billion in underwater securities at a $1.8 billion loss. This triggered a run on deposits, and in a matter of days, $42 billion in deposits were withdrawn.

WHAT'S NEXT?

Government officials are considering several initiatives to address the underlying issues that contributed to recent bank collapses. Their objective is to strengthen capital and liquidity standards for banks with more than $100 billion in assets. Among other things, banking regulators and lawmakers are considering:

- Imposing more rigorous stress-testing requirements on midsize banks,
- Tightening liquidity rules,
- Expanding FDIC deposit insurance coverage, which is currently limited to $250,000 per depositor, per bank, in each account ownership category,
- Increasing capital requirements,
- Reversing a 2018 law that relaxed regulation of midsize banks by increasing the "too big to fail" threshold from $50 billion in assets to $250 billion in assets, and
- Reevaluating regulatory oversight of banks' deposit mixes, deposit concentration and percentage of uninsured deposits.

Regulatory, legislative and oversight changes will target midsize and large institutions. However, stricter scrutiny of banking risks may trickle down to community banks.

HOW SHOULD COMMUNITY BANKS RESPOND?

In light of recent events, community banks need to review their risk management policies and procedures. The policies should meet regulators' expectations and help the bank withstand any further turmoil in the financial industry. Specifically, community banks should:

- Monitor deposit trends to ensure that deposit bases are diversified and that there aren't high concentrations of deposits in specific industries or groups of related customers,
- Review customers' average deposit sizes and avoid a high percentage of uninsured deposits,
- Evaluate their liquidity position and, if necessary, take steps to increase liquidity and build liquidity buffers,
- Watch out for accumulated losses in their securities portfolios, and
- Conduct periodic stress tests to evaluate their exposure to interest rate risk and other risks.

Your bank also should communicate with customers to be sure they understand why community banks aren't exposed to the same level of risk as the institutions that failed. (See "Communication is key for community banks" on page 2.)

STAY TUNED

In the coming weeks and months, community banks will need to monitor the regulatory and legislative response to this year's bank failures and the conditions that caused them. Although new laws or regulations likely won't affect your bank directly, they may serve as a guide to best practices that can help your bank satisfy regulators and reassure customers. ■

HOW CAN FINANCIAL DUE DILIGENCE SUPPORT YOUR LOANS?

Many currently problematic loans once looked good on paper — but now, aren't worth the paper they're printed on! To ensure your bank doesn't succumb to the lure of loans that seem to be — and are — too good to be true, it's important to have a policy of conducting proactive due diligence practices from the start. That way, you'll help your loan portfolios remain stable and profitable over time.

STEPS TO CONSIDER

Start the due diligence process as an auditor would. That is, before you open a borrower's financial statements, consider documenting the risks in the industry, applicable economic conditions, and the borrower's business operations and collateral sources.

This risk assessment identifies what's most relevant, where your greatest exposure lies, what trends you expect in this year's financials and which bank products the customer might need. Risk assessments save time because you're targeting due diligence on high-risk areas.

FINANCIAL RISK

Now tackle the financial statements, keeping in mind your risk assessment. First evaluate the reliability of the financial information. For statements prepared by an in-house bookkeeper or accountant, consider that individual's skill level and whether the statements conform to Generally Accepted Accounting Principles. If statements are CPA-prepared, consider the level of assurance: compilation, review or audit.

Comprehensive statements include a balance sheet, income statement, statement of cash flows and footnote disclosures. Make sure the balance sheet "balances" — that is, assets equal liabilities plus equity. You'd be surprised how often internally prepared financial statements are out of balance.

Statements that compare two (or more) years of financial performance are ideal. If they're not comparative, look at last year's statements. Then, note any major swings in assets, liabilities or capital. Better yet, enter the data into a spreadsheet and highlight changes greater than 10% *and* $10,000 (a common materiality rule of thumb accountants use for private companies). You should also highlight changes that failed to meet the trends you identified in your risk assessment. For example, you expected something to change more than 10% but it didn't.

Now ask yourself whether these changes make sense based on your preliminary risk assessment. Brainstorm possible explanations *before* asking the borrower. This allows you to apply professional skepticism when you hear borrowers' explanations.

RATIOS FOR ANALYSIS

Use your risk assessment to create a scorecard for each borrower. It often helps to discuss your risk

assessment with co-workers and to specialize in an industry niche.

One ratio that belongs on every scorecard is *profit margin (net income / sales)*. Every lender wants to know whether borrowers are making money. But a profitability analysis shouldn't stop at the top and bottom of the income statement. It's useful to look at individual line items, such as returns, rent, payroll, owners' compensation, travel and entertainment, interest, and depreciation expense. This data can provide reams of information on your client's financial health.

WHEN APPLYING RISK ASSESSMENT METRICS, IT'S WISE TO COMPARE A COMPANY TO ITSELF OVER TIME AND BENCHMARK IT AGAINST COMPETITORS, IF POSSIBLE.

Other useful metrics include *current ratio (current assets / current liabilities)*, which measures short-term liquidity or whether a company's current assets (including cash, receivables and inventory) are sufficient to cover its current obligations (accrued expenses, payables and current debt maturities). High liquidity provides breathing room in volatile markets.

In addition, *total asset turnover (sales / total average assets)* is an efficiency metric that tells how many dollars in sales a borrower generates from each dollar invested in assets. Again, more in-depth analysis — for example, receivables aging or inventory turnover — is necessary to better understand potential weaknesses and risks.

Finally, calculating the *interest coverage ratio (earnings before interest and taxes / interest expense)* provides a snapshot of a company's ability to pay interest charges. The higher a borrower's interest coverage ratio is, the better positioned it is to weather financial storms.

When applying these metrics, compare a company to itself over time and benchmark it against competitors, if possible. If customers' explanations don't make sense, consider recommending that they hire a CPA to perform an agreed-upon-procedures engagement, targeting specific high-risk areas.

WORTH THE EXTRA EFFORT

Digging deeper into the financial statements to determine what's really going on within the operations of existing and potential borrowers may seem unnecessary in the face of what they're already reporting. But to ensure those reports are based on sound facts and analysis, take a closer look. The health of your bank's loans depends upon it. ■

DON'T TAKE GOVERNMENT GUARANTEES FOR GRANTED

How to avoid jeopardizing your SBA loan guarantees

If your bank participates in U.S. Small Business Administration (SBA) lending programs, it must comply with all SBA requirements and standards to ensure that the government will honor its loan guarantees.

SBA lending offers significant benefits for banks. Under the 7(a) program, for example, the SBA guarantees up to 75% of loans to eligible small businesses (85% for loans of $150,000 or less), with a maximum loan amount of $5 million. These loans allow banks

to expand customer base, reduce risk, boost lending capacity (the guaranteed portion of these loans doesn't count toward a bank's legal lending limit), and improve liquidity (the guaranteed portion can be sold on the secondary market).

PRESERVE THE GUARANTEE

The key to the benefits of SBA lending is the government's guarantee. If a borrower defaults, the SBA will scrutinize the loan file to ensure that the lender has complied with SBA requirements, as well as SBA loan authorization and prudent lending practices. If the lender doesn't meet these standards, the SBA may reduce the amount of the guarantee (known as a "repair") or, in more extreme cases, deny the guarantee altogether.

Here are common reasons for a repair or denial:

Lien or collateral issues. Examples include failure to obtain the required lien position, failure to properly perfect a security interest or failure to fully collateralize the loan at origination when additional collateral was available (usually a repair).

Unauthorized use of proceeds. This involves disbursing proceeds for purposes inconsistent with the loan authorization (denial or repair, depending on the circumstances).

Liquidation deficiencies. These include failure to conduct a site visit, improper safeguarding or disposition of collateral, and misapplication of recoveries to the lender's loan (usually a repair, but could be a denial if the harm is the full value of the outstanding balance).

Undocumented servicing actions. This includes failing to renew liens when required, releasing or subordinating collateral without a documented business justification, and allowing hazard insurance to lapse on collateral that's later destroyed (usually a repair).

Early defaults. Typically, early defaults occur within 18 months if there are lender omissions, such as missing or unsupported verification of a required equity injection or missing or unsupported documentation of verification of borrower financial information with the IRS (possible denial if the SBA determines these omissions are the reason for the borrower's business failure).

SBA loan eligibility issues. These may involve an ineligible franchise, ineligible loan purpose or ineligible loan recipient — for example, a loan to an associate of the lender (usually a denial).

If the SBA denies or reduces a loan guarantee, your bank will have an opportunity to present its case to honor the guarantee. But this time-consuming process will require convincing evidence showing that the bank's actions were prudent and consistent with SBA requirements and the loan authorization.

REVIEW YOUR PROGRAM

To preserve the benefits of SBA loan guarantees, review your bank's SBA lending program. Make sure you have policies, procedures, checklists, controls and properly trained staff in place to ensure that your bank complies with SBA requirements. And be vigilant in monitoring SBA loans to avoid deficiencies that can jeopardize loan guarantees. ■

BANK WIRE

CFPB TARGETS "JUNK FEES"

In recent guidance, the Consumer Financial Protection Bureau (CFPB) highlighted two "junk fee" practices that, in its view, are likely unlawful:

1. Surprise depositor fees. Banks sometimes charge fees to consumers who deposit checks that bounce. Typically, this happens because check originators have insufficient funds in their accounts, but in some cases, depositors are victims of check fraud. Either way, the CFPB explains, "Charging a fee to the depositor penalizes the person who could not anticipate the check would bounce, while doing nothing to deter the originator from writing bad checks." According to the CFPB, indiscriminately charging these depositor fees likely violates the Consumer Financial Protection Act. A better approach is for banks to limit these fees to situations in which the depositor should have anticipated the check would bounce — for example, when the depositor has deposited several bad checks from the same originator.

2. Surprise overdraft fees. These fees — which may be imposed when a customer doesn't reasonably expect their actions to result in an overdraft — also may violate the law. One example is an "authorize positive, settle negative" transaction. This occurs when a consumer has sufficient available balance in the account when a transaction is initiated and authorized by the bank. But because of intervening authorizations, settlements or other complex processes, the financial institution finds the consumer's balance is insufficient at the time the transaction is settled. ■

SHOULD YOU AMEND YOUR QUALIFIED RETIREMENT PLANS?

Like many businesses, banks are facing a labor shortage. One way to help attract and retain qualified workers is to offer a competitive employee benefits package. The SECURE 2.0 Act of 2022 provides employers with several options for enhancing their 401(k) or other qualified retirement plans. For example, plans can now permit employees who suffer economic losses from a federally declared disaster to withdraw up to $22,000 penalty-free. Employees also can spread the tax on those withdrawals over three years — or avoid tax completely — by repaying the withdrawal and recontributing the funds to a tax-advantaged retirement account within three years. In addition, plans may increase the maximum loan amount for disaster victims from $50,000 to $100,000.

Starting in 2024, under SECURE 2.0, plans will be permitted to treat qualified student loan payments as elective deferrals for matching purposes. This can be an attractive benefit for employees who otherwise would have to choose between paying down their student debt and deferring salary to a qualified plan to get matching contributions. Other provisions allow employers to offer tax-advantaged emergency savings accounts to rank-and-file employees and to permit employees to receive fully vested employer contributions (including matching contributions) as after-tax Roth contributions. ■

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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.

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