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LIBOR NO MORE: HOW TO PREPARE FOR THE RATE'S EXPECTED DEMISE

DIG DEEPER TO AVOID FRAUDULENT FINANCIAL RESTATEMENTS

DOES YOUR WEBSITE COMPLY WITH TRUTH-IN-LENDING REGULATIONS?

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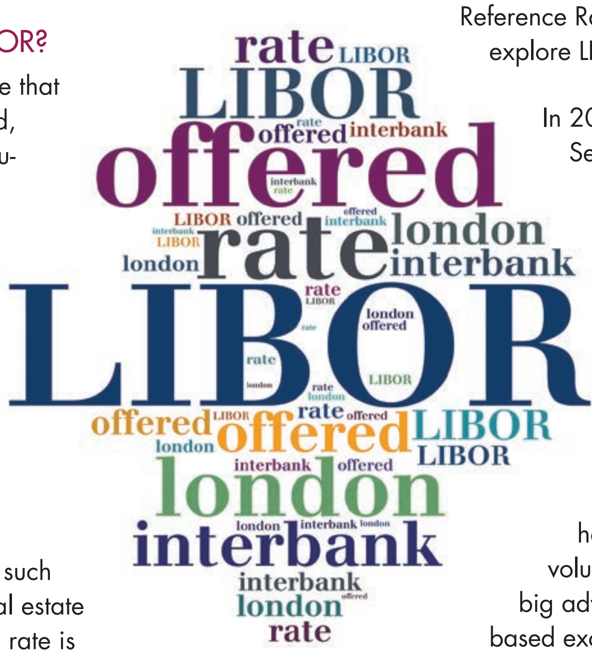
LIBOR NO MORE: HOW TO PREPARE FOR THE RATE'S EXPECTED DEMISE

For decades, financial institutions around the world have used the London Interbank Offered Rate (LIBOR) as a reference interest rate for loans and other financial instruments. Unfortunately, over the last several years, the marketplace has lost confidence in LIBOR because of a 2012 rate-setting scandal and gradual degradation of the rate's quality. LIBOR will likely be discontinued after 2021, and a global effort is currently underway to identify alternative reference rates. Although LIBOR will be around for at least a couple more years, community banks should begin preparing now for the rate's eventual discontinuation.

WHAT HAPPENED TO LIBOR?

LIBOR reflects the average rate that large banks pay for unsecured, short-term borrowing. It's calculated based on the average of rates submitted by approximately 20 "panel banks" and published daily for five currencies and seven maturities (ranging from overnight to 12 months). Community banks and other institutions commonly use LIBOR as an index to set the interest rate for adjustable-rate loans, such as mortgages, commercial real estate loans and business loans. The rate is also used in many hedging transactions, such as interest rate swaps — and debt instruments, such as trust-preferred securities.

In 2012, in the wake of the financial crisis, some panel banks were found to have been falsifying their rates to improve their trading positions linked to LIBOR. Since that time, a steady decline in unsecured interbank lending activity has caused panel banks to rely more heavily on expert judgment than on actual transactions in determining lending rates. As a result, LIBOR is highly susceptible to manipulation and might no longer be representative of the underlying market.



WHAT'S THE ALTERNATIVE?

Dissatisfaction with LIBOR led several industry groups and regulators to explore alternative benchmarks. In 2014, the Federal Reserve Board and the Federal Reserve Bank of New York established the Alternative Reference Rates Committee (ARRC) to explore LIBOR alternatives.

In 2017, the ARRC identified the Secured Overnight Financing Rate (SOFR) as its preferred risk-free reference rate. (See "An introduction to the SOFR" on page 3.) Although there's no requirement for banks to use SOFR — and it's possible that other alternatives will emerge — a number of institutions have already adopted SOFR voluntarily for certain products. A big advantage of this rate is that it's based exclusively on actual transactions between banks. Because there's no expert judgment involved, it's less susceptible to manipulation than LIBOR. Also, because the volume of transactions underlying SOFR is substantial and the rate is virtually risk-free, it's believed to provide a good representation of general funding conditions in U.S. money markets.

Although SOFR appears to be a viable alternative to LIBOR, it's important to understand the differences between the two rates. For one thing, SOFR is a *secured* rate, while LIBOR is an *unsecured* rate. Because SOFR reflects lower risk, it is lower than LIBOR. Another significant difference is that SOFR is an overnight rate, while LIBOR is calculated for a range of maturities. According to the Federal Reserve, however, "building liquidity in the derivative markets linked to SOFR will help with the development of a term structure for SOFR."

WHAT SHOULD YOU BE DOING NOW?

LIBOR will not disappear overnight, but it's a good idea for community banks to begin preparing for the rate's potential replacement in 2022. Without a contingency plan, the end of LIBOR may cause uncertainty and confusion about how to determine interest rates for products tied to LIBOR. And this could expose your bank to a variety of risks.

The first step is to take an inventory of your loan agreements and other contracts to identify products that contain LIBOR-based pricing. Next, determine whether these contracts include appropriate "fallback" language. The language should specify what happens if LIBOR is discontinued to help ensure a smooth transition to SOFR or another new reference rate. Consider amending these contracts, if necessary, to include appropriate fallback language, and incorporate such language into new contracts.

WHAT CAN YOU DO TO MAKE A SMOOTH TRANSITION?

To prepare for LIBOR's discontinuation, work with your bank's advisors to identify an appropriate reference rate for your bank and draft fallback language that reflects your particular circumstances. Keep in mind that you'll likely need to adjust the interest rate calculations in your contracts to reflect differences between LIBOR and the new reference rate. The ARRC has developed recommended fallback language for various types of products and LIBOR replacement strategies.

AN INTRODUCTION TO THE SOFR

The Secured Overnight Financing Rate (SOFR) has emerged as the preferred risk-free LIBOR alternative. The rate — published by the Federal Reserve Bank of New York at 8:00 a.m. Eastern time each business day — represents the cost of borrowing cash overnight in the repurchase agreement (repo) market, collateralized by U.S. Treasury securities. The Alternative Reference Rates Committee (ARRC) chose SOFR in part because it's "robust, is not at risk of cessation, and it meets international standards."

According to the ARRC, "SOFR is a much more resilient rate than LIBOR because of how it is produced and the depth and liquidity of the markets that underlie it." Plus, because it's an overnight, secured rate, SOFR is more representative of financial institutions' actual funding practices. For more information, visit ARRC's website at newyorkfed.org/arrc.

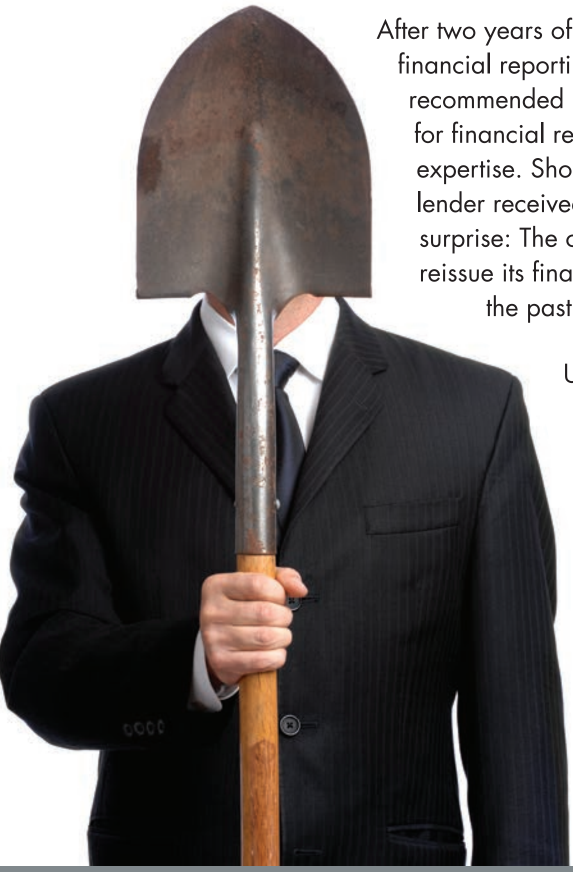
Also, keep an eye on regulatory and accounting developments. Both the IRS and the Financial Accounting Standards Board have issued proposals to provide banks with tax and accounting relief as they transition away from LIBOR. ■

DIG DEEPER TO AVOID FRAUDULENT FINANCIAL RESTATEMENTS

Anyone can make a mistake, including a borrower who provides corrections to his or her business's financial statements. But, to ensure the corrections aren't covering up fraudulent activity, it's important to take a second look when your borrowers present you with financial restatements.

ACCIDENT OR INTENTION?

When Sam took over his father's consulting company, his lender quickly discovered that Sam's accounting skills hadn't kept pace with his business consulting abilities. The company engaged in various types of related-party transactions, including seller financing and a leasing arrangement with the previous owner. Sam also seemed unsure when to capitalize or expense supplies and equipment.



After two years of sloppy, delayed financial reporting, Sam's lender recommended hiring an accountant for financial reporting and tax expertise. Shortly thereafter, the lender received an unwelcome surprise: The company needed to reissue its financial statements for the past three years.

Ultimately, the restatements revealed that Sam had overstated profits by more than $2 million over the last three years. When confronted with the news, he confessed that he'd been intentionally padding profits, because he didn't want to disappoint his father.

The lender called the company's $3 million line of credit. So Sam was forced to confess his mismanagement to his father, who eventually left retirement to turn around the business.

RESTATEMENTS TYPICALLY OCCUR WHEN THE COMPANY'S FINANCIAL STATEMENTS ARE SUBJECTED TO A HIGHER LEVEL OF SCRUTINY.

UNETHICAL OR JUST BAD PRACTICE?

Not all restatements result from misleading or unethical management. Often owners and managers just aren't on top of today's increasingly complex accounting rules — and honest mistakes or misinterpretations cause a restatement.

Restatements typically occur when the company's financial statements are subjected to a higher level of scrutiny. For example, restatements may happen when a borrower converts from compiled financial statements to audited financial statements or decides to file for an initial public offering. They also may be needed when the borrower brings in additional internal (or external) accounting expertise, such as a new controller or audit firm.

The restatement process can be time-consuming and costly. Regular communication with interested parties — including lenders and shareholders — can help overcome the negative stigma associated with restatements. Management also needs to reassure employees, customers and suppliers that the company is in sound financial shape to ensure their continued support.

COMMON ISSUES

Recognition errors are one of the most common causes of financial restatements, according to a report from proxy research firm Glass, Lewis & Co. Borrowers typically make these mistakes when accounting for leases or reporting compensation expense from backdated stock options.

Income statement and balance sheet misclassifications also cause a large number of restatements. For instance, a borrower may need to shift cash flows between investing, financing and operating on the statement of cash flows. Other leading causes of restatements are equity transaction errors, such as improper accounting for business combinations and convertible securities, and valuation errors related to common stock issuances. Referred stock errors and the complex rules related to acquisitions, investments, revenue recognition and tax accounting also can cause restatements.

You can minimize your dependence on bad numbers by requiring independent audits for private borrowers. You also may request cost-effective internal control testing procedures for prospective and high-risk borrowers, such as those that engage in hedge accounting, issue stock options, use special purpose or variable interest entities, or consolidate financial statements with related parties.

UNDERLYING REASONS

You can't determine what action to take about a financial restatement until you understand the underlying reasons for it. A careless mistake isn't necessarily unethical, yet it may be a sign of ongoing problems in the business that need to be addressed. Carefully evaluate borrowers' financial restatements so that your bank can head off potential bad loans before they happen. ■

DOES YOUR WEBSITE COMPLY WITH TRUTH-IN-LENDING REGULATIONS?

Your bank's website may serve a variety of purposes, but ultimately it's a form of advertising. That means that any descriptions of your bank's loans, credit cards and other lending products on the site must comply with the Truth in Lending Act and Regulation Z. In recent years, banking regulators and potential litigants have been scrutinizing banks' websites to identify potential compliance violations. So it's a good idea to review your website carefully and correct any problems before they become the subject of an examination or lawsuit.

ACCURACY MATTERS

If your website advertises specific credit terms, Regulation Z requires that you only state terms that you're actually prepared to offer. For example, you can't advertise a low annual percentage rate (APR) that will not in fact be available. But you're permitted to advertise terms that will be offered for a limited period — or will become available in the future.

Under Regulation Z, advertising certain terms triggers additional disclosure requirements. For closed-end credit offerings, such as mortgages and auto loans, these "triggering terms" include:

- The amount or percentage of any down payment (for example, "only 5% down," "as low as $100 down"),
- The number of payments or repayment period (for example, "30-year mortgage," "48-month payment terms"),
- Payment amounts (for example, "$500,000 loan for just $1,650 per month"), and
- Finance charges (for example, "$500 total cost of credit").

If your website advertises any of the above terms, it must provide additional disclosures. For instance, you must show the amount or percentage of the down payment. (You need not use the term "down payment" — something like "10% cash required from buyer" will suffice.) In addition, the site needs to disclose the repayment terms, reflecting repayment obligations over the full term of the loan, including any balloon payment. You're permitted to disclose terms based on unit cost, such as "48 monthly payments of $27.83 per $1,000 borrowed." Finally, your site must reveal the APR and, if applicable, the possibility that it will increase. You must use the term "annual percentage rate" or the abbreviation "APR."

OTHER DISCLOSURE RULES

For open-ended credit (such as credit cards), advertising that mentions any terms required to be disclosed at account-opening triggers additional disclosure requirements. So, for example, if your website states that your credit card has "no annual fees," it must also disclose:

- Any minimum, fixed, transaction, activity or similar charge that constitutes a finance charge,
- The APR and, if applicable, the fact that a variable periodic rate applies, and
- Any membership or participation fee that could be imposed.

Similar disclosure rules apply to home equity line-of-credit applications that your website includes.

CLEAR AND CONSPICUOUS

Be sure that required disclosures are "clear and conspicuous." In the Summer 2019 issue of the Consumer Financial Protection Bureau's *Supervisory Highlights*, the Bureau noted that examiners had found several instances in which banks' websites failed to meet this standard.

In some cases, for example, disclosures were available to consumers via a hyperlink that was not labeled in a way that referred to the disclosures. To view the disclosures, they would have to click on the link (which was not clear or conspicuous) and then navigate through an online application before arriving at the disclosures. In other cases, to view disclosures, consumers first had to click on multiple hyperlinks and then complete an eight-page application.

COMPLIANCE IS KEY

Information on your bank's website can be viewed by virtually anyone, so it's critical to review it regularly for compliance with all applicable consumer protection regulations. These include the Truth-in-Lending requirements described here, as well as those related to the Truth in Savings Act, the Equal Credit Opportunity Act, and the Unfair, Deceptive, or Abusive Acts or Practices (UDAAP) provisions of the Dodd-Frank Act. ■

BANK WIRE

RISK-BASED BSA/AML EXAMINATIONS

In July 2019, the federal banking agencies issued a *Joint Statement on Risk-Focused Bank Secrecy Act / Anti-Money Laundering Supervision*. The statement emphasizes the agencies' commitment to tailoring examination plans to each bank's particular risk profile. Be prepared for examiners to allocate more resources to your bank if you have a higher overall BSA/AML risk profile or to higher-risk areas within your bank in order to examine the adequacy of your BSA/AML compliance program.

How do examiners assess a bank's risk profile? Among other things, they look at the bank's own BSA/AML risk assessment, independent testing or audits, analyses and conclusions from previous examinations, and risk management practices. Conducting a comprehensive BSA/AML risk assessment is one of the most effective tools for streamlining the examination process and inspiring examiner confidence in the quality of your BSA/AML compliance program. ■

CBLR FRAMEWORK EASES CAPITAL REQUIREMENTS

Recently the Federal Deposit Insurance Corporation (FDIC) finalized its community bank leverage ratio (CBLR) framework. This optional framework relieves the burden on qualifying community banks by eliminating the need to calculate and report risk-based capital ratios. Community banks that elect to use the framework are deemed to have met the well-capitalized ratio requirements for purposes of Section 38 of the Federal Deposit Insurance Act. To qualify, a bank must have:

- A leverage ratio greater than 9%,
- Less than $10 billion in average total consolidated assets,
- Off-balance-sheet exposures no greater than 25% of total consolidated assets, and
- Trading assets plus trading liabilities not greater than 5% of total consolidated assets.

In addition, the bank must not be an "advanced approaches banking organization." This generally includes firms with at least $250 billion in total consolidated assets or $10 billion in total on-balance-sheet foreign exposure, and their depository institution subsidiaries.

The framework, effective as of January 1, 2020, also provides a two-quarter grace period. This allows banks that cease to satisfy one or more of the requirements time to regain compliance (if eligible) with the CBLR framework or to comply with generally applicable capital rules. ■

ARE YOUR BOARD MEMBERS APPROVING LOANS?

According to a recent survey by BankDirector.com, the board or a board-level committee approves loans that meet specific criteria at more than 75% of banks (100% of banks with less than $500 million in assets). But there may be disadvantages to this practice, including potential director liability in connection with individual loan approvals and distraction of directors from critical "big picture" activities, such as strategic planning. ■

FASB APPROVES CECL AND LEASE ACCOUNTING DELAYS

The FASB recently delayed the effective date of the current expected credit losses (CECL) model by two years for public business entities that aren't SEC filers and for private companies. It also delayed the effective date of the new lease accounting standard for private companies by one year. For calendar-year-end companies, CECL will take effect in 2023 (including interim periods) and the lease standard in 2021. ■

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 national firms, acxell provides internal audit, regulatory compliance, BSA/AML, information technology 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.

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