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COMMUNITY BANKING ADVISOR

LENDING IN THE AGE OF COVID-19: ACCOUNTING FOR LOAN MODIFICATIONS

BOOST NONINTEREST INCOME FOR A HEALTHIER BOTTOM LINE

WHAT DOES THE PANDEMIC MEAN FOR BANK BRANCHES?

BANK WIRE

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LENDING IN THE AGE OF COVID-19: ACCOUNTING FOR LOAN MODIFICATIONS

During the COVID-19 pandemic, most banks have entertained requests by struggling borrowers to modify their loans. Potential accommodations include payment deferrals, fee waivers, interest rate reductions, loan extensions and forgiveness of interest or principal.

Loan modifications create accounting challenges for banks, which must determine whether a particular modification constitutes a troubled debt restructuring (TDR). Fortunately, Congress and the federal banking regulatory agencies have provided some relief. The CARES Act, together with guidance from regulators, gave banks greater flexibility to restructure debt for borrowers affected by COVID-19 without triggering the possibly undesirable consequences of a TDR classification.

GETTING INTO TROUBLE

Under Generally Accepted Accounting Principles (GAAP), a loan modification is a TDR if a bank "for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider." Banks are required to measure TDRs for impairment, which can result in valuation allowances or losses and criticism by examiners, and may have a negative impact on capital. Moreover, these loans will likely need to be placed on nonaccrual status.

Determining whether a modification constitutes a "concession" can be challenging. But, in general, a concession has been granted if the bank doesn't expect to collect all amounts due, including interest accrued at the loan's original interest rate. It doesn't, however, include an "insignificant" delay in payment.

It's also important to keep in mind that, even if a loan modification is a concession, it's not a TDR unless it's granted on account of the borrower's financial difficulties. So, for example, a bank that reduces the interest rate on a loan to a healthy borrower to retain its business has not done a TDR.

RELIEF UNDER THE CARES ACT

Section 4013 of the CARES Act provides temporary relief from the TDR accounting rules. Relief is available for a loan modification if it is:

- Made for reasons related to COVID-19,
- Made to a loan that was not more than 30 days past due as of December 31, 2019, and
- Executed between March 1, 2020, and the *earlier* of 1) 60 days after termination of the declared national emergency or 2) December 31, 2020 (the "applicable period").

WHAT ABOUT ADDITIONAL MODIFICATIONS?

In August 2020, the Federal Financial Institutions Examination Council (FFIEC) issued a joint statement on additional loan accommodations related to COVID-19. The statement clarifies that, if a loan modification is accounted for under Section 4013 of the CARES Act, additional modifications may also be eligible for the same treatment, provided they independently meet the criteria.

For modifications that are not accounted for under Sec. 4013, banks should consider the cumulative effect of the original modification and any additional modifications in determining TDR status. So, for example, if several modifications combined meet the criteria outlined in the revised interagency statement — all are COVID-19 related, payments are current, and modifications are short term (that is, six months or less in total) — the bank may continue to presume that the borrower is not experiencing financial difficulties.

Banks may account for eligible modifications either under Sec. 4013 or in accordance with GAAP. Under Sec. 4013, the bank isn't required to apply TDR accounting during the term of the loan modification, and it need not measure impairment associated with concessions or report these loans as TDRs in its regulatory reports. If a modification is not eligible under Sec. 4013 (for example, because it's made after the applicable period) or if the bank elects not to apply it, the bank should determine whether a loan modification is a TDR under existing accounting rules (subject to the interagency guidance discussed below).

INTERAGENCY GUIDANCE

In April 2020 the federal banking regulators issued a *Revised Interagency Statement on Loan Modifications by Financial Institutions Working with Customers Affected by the Coronavirus*. The revised statement updates an earlier statement to reflect the passage of the CARES Act and the impact of Sec. 4013 on loan modifications.

The revised statement also provides guidance on accounting for loan modifications outside the scope of Sec. 4013. To reduce the burden on banks, the statement encourages them to consider loan modifications for borrowers affected by COVID-19, provided they are approached in a safe and sound manner. The statement emphasizes that loan modifications don't automatically result in TDRs. It also allows banks to presume that a borrower is *not* experiencing financial difficulties if:

1. The modification was in response to the national emergency,
2. The borrower was current on the loan (not more than 30 days past due) at the time of the modification, and
3. The modification was short term (for example, six months).

The revised statement advises banks to refer to applicable regulatory guidance and their internal accounting policies to determine whether loans should be placed on nonaccrual status. However, short-term arrangements discussed in the statement generally should not be reported as nonaccrual.

HAVE YOUR DOCUMENTS IN ORDER

If you modified loans during 2020 for borrowers affected by COVID-19, it's critical to retain documentation of your decision-making process. To enjoy the accounting relief provided by the CARES Act and agency guidance, you'll need to show that concessions were made as a result of the pandemic's impact and not on account of financial difficulties caused by other factors. ■

BOOST NONINTEREST INCOME FOR A HEALTHIER BOTTOM LINE

In a difficult economy, community banks need to look beyond interest income and seek revenue streams that can help them maintain profitability. Bank managers need to evaluate potential noninterest income sources and determine which will be most likely to help shore up their bottom line going forward.

SOME STRATEGIES TO CONSIDER

Common sources of noninterest income include:

- Overdraft and nonsufficient funds charges, which are highly scrutinized, and
- Gains on the sales of loans and investment securities.

Noninterest income also may be derived from various products and services — including insurance and annuity products, as well as brokerage, trust and financial planning services.

Waivers and collections. Community banks have a history of being easy on customers by waiving NSF fees and other penalties anytime they receive complaints. Although it's important for bank personnel to have the discretion to waive these fees, high waiver rates — some estimates are higher than 50% — can quickly wipe out substantial revenue.

To keep waivers under control, set a target level for discretionary waivers and train bank personnel to understand the significance of noninterest income, make good decisions regarding fee waivers and handle customer complaints. If you haven't already done so, try automating the fee initiation process so that nothing falls through the cracks, and incorporate waiver targets into your incentive compensation decisions.

Finally, be sure to include fee waiver data in management reports, which will let you monitor results.

Competitive fees. Banks often miss opportunities to charge higher fees because they fail to keep tabs on their competitors. Identify the predominant banks in your market and procure their fee schedules. Comparing competitors' fees to your own may uncover significant pricing opportunities.

This doesn't mean you should increase your fees to match the highest-priced banks in your area. However, if you find your fee schedule on the low end of the spectrum, a modest increase can have a substantial impact on your bank's revenue. Any change in fee structure should be monitored closely to ensure the strategy produces the desired outcome.

Relationship value pricing. Relationship value pricing can be a highly effective strategy for enhancing fee revenue. It sets prices based on the overall value of a banking relationship with a customer or group of customers, such as a family or a business and its employees.

In its simplest form, relationship value pricing might involve package deals for products or services.

A common example is free checking accounts for customers who maintain a minimum loan balance. A more sophisticated approach is to develop customized pricing based on a valuation of the products and services a specific customer receives.

For relationship value pricing to work, your bank must carefully analyze the costs, benefits and potential profitability of each customer relationship. It's also critical to have systems that monitor the relationship. Banks often lose revenue because they're unaware that the relationship has changed. For example, a bank might continue providing free checking even though the related loan has fallen below the minimum balance or has been paid off.

Insurance policies. Insurance policies on the lives of directors, officers and other key employees can be cost-effective tools for boosting noninterest income. Your bank can buy coverage or use "split-dollar" arrangements to share the costs and benefits of these policies with employees.

Bank-owned life insurance (BOLI) is often used to fund supplemental executive retirement plans, other nonqualified deferred compensation plans and retiree health benefits. BOLI can be a powerful planning tool because a life insurance policy's cash value grows on a tax-deferred basis and, if the policy is held until the insured employee dies, the death benefit is generally tax-free.

A caveat: To enjoy these tax benefits, your bank must comply with strict notice and consent requirements before buying a policy on an employee's life.

OBTAIN PROFESSIONAL ADVICE

No set of noninterest income strategies is right for every community bank. It's important to analyze your bank's particular circumstances to identify the noninterest income streams that will be most beneficial. To that end, your professional financial advisor can provide up-to-date information on these and other potential methods for increasing your noninterest income over the long term. ■

WHAT DOES THE PANDEMIC MEAN FOR BANK BRANCHES?

Even before the COVID-19 pandemic, foot traffic at community bank branches was on the decline, as an increasing number of customers discovered the ease and convenience of conducting banking transactions online. The pandemic has accelerated the trend that was well underway, forcing many customers to shift to digital banking whether they like it or not. As it turns out, many of them do like it. And many experts predict that much, or even most, of the prepandemic foot traffic at bank branches will remain online even after we return to "normal."

That's not to say that branch banking is a thing of the past. It's likely that there will always be a place for bank branches, particularly for community banks. But the number of branches will probably shrink and the role of the branch will need to adapt to an increasingly digital model.

MAINTAINING THE PERSONAL TOUCH

Clearly, given recent developments, all banks need to ensure that their digital houses are in order. At the same time, community banks should not lose sight of

the fact that their competitive advantages are largely derived from their physical presence in the community and their ability to offer face-to-face engagement and personalized services.

To maintain the personal touch, community banks will need to focus their technology efforts on developing digital banking experiences that replicate — as much as possible — the type of customer engagement that historically has differentiated them from the competition. For example, you might want to set up:

- Live chat via the bank's website or mobile app,
- Two-way texting with customer service representatives,
- Opportunities to obtain information and communicate with the bank via social media, and
- Videochatting capabilities on ATMs.

Community banks also should take advantage of the digital ability to collect and analyze information about customers and prospective customers. Armed with this knowledge, banks can offer their customers personalized services and customized solutions and advice.

THE EVOLVING ROLE OF THE BRANCH

It's highly unlikely that bank branches will become obsolete anytime soon. But as customers recognize the benefits of banking online, the branch's role is becoming less transactional and more educational. Some customers will never embrace online banking, but even customers who no longer rely on a branch to transfer funds or make a deposit may still prefer face-to-face interaction when they have questions about the bank's products and services or seek financial advice. And physical locations will always be needed for things like safe deposit boxes and instant cashier's checks or money orders.

[COMMUNITY BANKS SHOULD TAKE ADVANTAGE OF THE DIGITAL ABILITY TO COLLECT AND ANALYZE INFORMATION ABOUT CUSTOMERS AND PROSPECTIVE CUSTOMERS.]

The branch also may complement a bank's online presence by providing customers with hands-on opportunities to learn about the bank's digital offerings. At many branches, for example, tablet-toting tellers are coming out from behind their counters to answer customers' questions and demonstrate the bank's digital banking tools.

BRANCHING OUT

Although the branch is likely here to stay, community banks cannot afford to ignore the increasingly digital nature of banking. All banks should focus on building or expanding their online presence while creating in-person customer experiences at their branches that can't be duplicated elsewhere. ■

BANK WIRE

INTERIM RULE PROVIDES TEMPORARY RELIEF FROM FDICIA REQUIREMENTS

In late October 2020, the FDIC issued an interim final rule temporarily suspending specific requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) for banks that experienced significant asset growth in 2020. This is good news for community banks, many of which saw their balance sheets swell last year as a result of the Paycheck Protection Program and other government stimulus efforts.

The FDICIA imposes stricter auditing, reporting and governance obligations on institutions as their consolidated total assets cross the $500 million and $1 billion marks. For example, when assets reach $500 million, banks must obtain annual independent audits and meet several other reporting requirements. And at $1 billion in assets, banks must, among other things, assess the effectiveness of internal control over financial reporting and maintain a fully independent audit committee.

Under the interim final rule, for fiscal years ending in 2021, banks may determine whether they are subject to FDICIA requirements based on 1) their consolidated total assets as of December 31, 2019, or 2) their consolidated total assets as of the beginning of their fiscal year ending in 2021 — whichever is less. Note that the interim rule doesn't relieve banks of any otherwise applicable statutory or regulatory audit and reporting requirements. ■

SIMPLIFIED PPP LOAN FORGIVENESS

Handling loan forgiveness applications under the Paycheck Protection Program (PPP) can be complicated for lenders. Fortunately, in October the Small Business Administration, with support from the Department of the Treasury, released a simpler forgiveness application designed to streamline the process for PPP loans of $50,000 or less. The new application — Form 3508S — is only two pages, and the simplified process exempts eligible borrowers from the need to reduce the forgiveness amount based on reductions in full-time equivalent employees, salary or wages.

This change provides welcome relief to community banks. However, industry groups have urged Congress to increase the threshold to $150,000. ■

GET READY FOR THE LIBOR TRANSITION

The London Interbank Offered Rate (LIBOR), as a reference interest rate for loans and other financial instruments, will be discontinued in about a year. As banks prepare for the transition away from LIBOR, it's critical to consider its impact on risk management. A recent joint statement by the Federal Financial Institutions Examination Council (FFIEC) highlights the potential risks that banks will need to prepare for, including:

- Operational difficulty in quantifying exposure,
- Financial, valuation and model risk related to reference rate transition,
- Inadequate risk management processes and controls to support transition, and
- Consumer protection-related risks.

Other risks include the limited ability of third-party service providers to support operational changes and potential litigation and reputational risk arising from reference rate transition. ■

acxell ("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 other firms, acxell provides internal audit, regulatory compliance, BSA/AML, information technology, SOX/FDICIA 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.

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For **Solutions** *to your risk management needs, please contact our service coordinators at (877) 651-1700, or log-on to www.acxellrms.com to learn more.*

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