Financial Lending Notes

A Newsletter for Commercial Lenders Winter 2019

Overcoming Challenges

Five Things to Discuss With Your Borrowers

Despite the robust economy as reflected by solid GDP growth over the past few quarters, many small businesses are facing some serious challenges. If these challenges are left unchecked, some of these businesses could face significant financial obstacles in the coming months.

As a banker, you can be proactive by talking to your small business borrowers about these challenges and how you can help overcome them. Following are five things to include in your discussion.

1. Dealing With Disruption

Almost every industry today is having to deal with some sort of disruption. These disruptions are usually caused by technological advances, especially the Internet and digital technologies. For example:

- Amazon, eBay, and other online sellers have completely changed the game for retail businesses. So has the dominance of retail giant Wal-Mart. Small retailers have to be cost-conscious and nimble to survive in today's retail landscape.
- Uber, Lyft, and other ride-sharing services are threatening the existence of the taxi cab industry, which has had a monopoly on driving customers from point A to point B for more than a century.
- Carvana, TrueCar, and Vroom enable customers to buy cars without ever having to set foot in a traditional dealership.

Ask borrowers if there are any technological developments in their industry that have the disruption potential of an Amazon, Uber, or TrueCar. If there are, discuss things borrowers could be doing right now to maintain their competitive advantage as they prepare for an uncertain future.

2. Finding Affordable Labor

Last September the unemployment rate fell to its lowest level in nearly 50 years. The economy is now essentially at full employment as there are more jobs available than there are people looking for work.

This is great news for workers, but it can present tremendous challenges for growing businesses looking to hire and retain employees. Highly skilled and trained employees in particular are in high demand and can often pick and choose from attractive, well-paying jobs.

Ask borrowers if they have thought about their current and future labor needs and whether they have a strategy for meeting them. For example, will they need to offer higher wages and better benefits to attract and retain employees? If so, can they pass the higher costs on to customers, or will they have to absorb them?

Also, do they have succession plans for replacing older workers who may be retiring in the next few years? For example, are they identifying and grooming younger employees to fill these positions?

3. Managing Tariff Costs

The tariffs that were implemented in early 2018 on imports of steel, aluminum, and other foreign goods have had a serious financial impact on some industries. In a survey published in October by the National Center for the Middle Market at Ohio State University, one-third of respondents said they expect their profits to suffer as they absorb higher costs due to tariffs.

The biggest impact of the tariffs will be on companies that produce and move goods, such as manufacturers, wholesalers, construction companies, and retailers. Nine out of ten wholesalers, six out of ten manufacturers and construction companies, and half of retailers said they expect their costs to rise due to tar-

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2 Three New Accounting Pronouncements

3 Revisions to HVCRE Rules

4 Beneficial Ownership Rule

Accounting Update

Get Ready for These Three Accounting Pronouncements

In the world of accounting pro-nouncements, it can sometimes take years from the time a pronouncement is made until it becomes effective. This is to give accountants and businesses plenty of time to prepare for the resulting changes to accounting practices.

There are several accounting pronouncements from recent years that will become effective soon. This makes now a good time to assess how these pronouncements could affect your borrowers and your bank.

New Lease Accounting Standard

ASU No. 2016-02, commonly referred to as the new lease accounting standard, has been called one of the most drastic changes ever made to public accounting standards. It will require businesses that lease assets (including vehicles, equipment, and real estate) for more than one year to report lease obligations as liabilities on the balance sheet.

The deadline for private companies to begin adopting the new lease accounting standard is annual reporting periods beginning after December 15, 2019. Public companies are required to adopt the new standard for annual reporting periods beginning after December 15, 2018.

Businesses that prepare GAAP-compliant financial statements will have to recognize assets and liabilities for both capital and operating leases on their balance sheet if the leases exceed one year in duration. More specifically, they must report a right-to-use asset and corresponding liability, discounted to present value, for lease payment obligations.

Because the new standard will result in new liabilities being listed on the balance sheet, it is likely to have an adverse effect on business' liquidity, leverage, and debt service coverage ratios. This, in turn, could make it more difficult for businesses to qualify for new commercial loans and comply with covenants in loan agreements for existing loans.

Fundamental changes could be in store for loan underwriting and structuring of debt covenants once the new lease accounting standard becomes effective. This makes it critical to be proactive in addressing these changes with borrowers well in advance of the effective date.

New Revenue Recognition Standard

ASU 2014-09, commonly referred to as the new revenue recognition standard, creates a new principles-based revenue recognition model. It is based on the core accounting principle that revenue should be recognized in an amount that reflects the compensation a business expects to receive as it transfers goods or services to customers.

The deadline for private companies to begin adopting the new revenue recognition standard is annual reporting periods beginning after December 15, 2018. Public companies were required to adopt the new standard for annual reporting periods beginning after December 15, 2017.

Contractors and construction firms are among the businesses that will be most impacted by the new revenue recognition standard. These businesses must determine the likelihood of collecting revenue before applying the standard to contracts, which will require evaluating customer credit risk.

First, businesses should identify the performance obligations in each contract and determine the transaction price. The next step is to allocate the transaction price to the performance obligations. Revenue should then be recognized at the time when goods or services are transferred to the customer.

Contractors will still usually be able to use the percentage of completion accounting method. And they won't have to recalculate completed contracts once the new standard becomes effective. Plan to sit down soon with borrowers impacted by the new revenue recognition standard to discuss its implications.

New Current Expected Credit Loss Standard (CECL)

This new standard, which will change how banks calculate credit loss reserves, represents a drastic shift for the financial services industry. Once CECL becomes effective, banks will no longer calculate reserves based on losses incurred in the past, but rather on expected future losses.

In the run-up to the financial crisis, banks' loan loss reserves shrank by 10 percent, while loan volume rose by 44 percent. The FASB adopted CECL in an effort to reduce credit risk by improving accounting for loan losses and better matching the cost of risk (losses) with the revenue recognized on the loan (interest and fees). Banks will have to assess potential losses when putting financial assets on the books instead of setting aside reserves on loans where losses appear probable.

The deadline for CECL implementation is annual reporting periods beginning after December 15, 2019 for banks that file with the SEC and annual reporting periods, including interim periods, beginning after December 15, 2021 for non-SEC filing banks.

Contact us to schedule an appointment if you have questions about these accounting pronouncements.

Regulatory Update

New HVCRE Capital Regulations Proposed

Last May, Congress passed the Economic Growth, Regulatory Relief and Consumer Protection Act (EGRRCPA). To conform the regulatory definition of HVCRE to the changes made by Section 51 of the EGRRCPA, banking agencies have recently proposed revisions to the capital rules regarding HVCRE, which imposes a 50 percent heightened capital requirement on certain commercial real estate loans.

The proposed new capital regulations would narrow how an HVCRE exposure is defined by requiring that a loan where more than 50 percent of the proceeds is intended to improve real property into income-producing property. HVCRE-ADC exposure would be defined as a loan secured by improved property or land that:

- Primarily finances, has financed, or refinances the acquisition, development, or construction (ADC) of real property
- Is intended to provide financing to acquire, develop, or improve this real property into income-producing property
- Is dependent on future income, sales proceeds, or refinancing from such property to repay the loan

HVCRE-ADC does not include a loan that finances the acquisition, development, or construction of properties that are one- to four-family residential properties, real property that would qualify as an investment in community property, or agricultural land. It also excludes improvements to existing income-producing improved real property secured by a mortgage if the income can support the debt service and expenses of the property (e.g., owner-occupied real estate).

Finally, HVCRE-ADC does not include any loan that was made prior to January 1, 2015.

To avoid being classified as HVCRE-ADC, proposed new regulations would also require that the loan-to-value ratio be less than or equal to the maximum regulatory LTV for the particular property type. They would also require borrowers to contribute a minimum of 15 percent of the property's appraised "as completed" value as capital. Real property including appreciated land value can be included among this capital. So can cash, marketable assets, and out-of-pocket expenses paid by the developer before closing.

Contributed capital must be in place before the bank funds the loan, and the borrower must agree to keep the contributed capital in the project until the loan is reclassified as non-HVCRE-ADC.

In addition, the proposed new regulations would allow HVCRE status to end before an ADC loan is replaced with permanent financing in the following scenario:

1. Construction or development of the property being financed is substantially completed, and
2. The cash flow generated by the property is adequate to support the property's expenses and debt service in accordance with the institution's underwriting for permanent loans.

Small Business Challenges

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iffs. Most said they plan to pass higher costs on by raising prices.

Ask borrowers not only whether tariffs are affecting their business, but also if they're affecting businesses along their supply chain. Do they have alternate supply sources lined up in case current suppliers raise their prices due to higher tariff costs? And do they plan to pass along higher costs by raising their own prices?

4. Handling Rising Interest Rates

The Federal Reserve continued its aggressive rate hike campaign last year in an effort to bring interest rates up from historical lows to more normal levels. The Fed has stated that its goal is to bring the federal funds rate up to 3.0 percent in 2019 and 3.5 percent in 2020.

Ask borrowers what impact rising interest rates could have on their overall financial picture. This is especially critical for borrowers carrying a lot of debt at variable rates. Also talk to borrowers about derivatives and hedging tools that could help mitigate interest rate risk and the impact of rising rates on their business.

5. Preparing for a Slowing Economy

Finally, you should talk to borrowers about how prepared they are for a slowdown in economic growth.

Some economists believe that the strong GDP growth we saw in 2018 was due largely to the corporate tax cuts and that this impact will start to wane this year. The Federal Open Market Committee (FOMC) is projecting GDP growth of 2.5% in 2019 and 2.0% in 2020.

Ask borrowers what the impact will be on demand for their products and services if the economy cools down and whether they have contingencies in place to address these scenarios.

Give us a call if you'd like to discuss in more detail these and other questions to ask borrowers.

Beneficial Ownership Rule Now in Effect

The Final Rule on Customer Due Diligence (CDD) Requirements for Financial Institutions went into effect last spring. This rule requires covered financial institutions, including community banks, to verify the identity of their legal entity customers' beneficial owners as part of their Bank Secrecy Act (BSA) compliance.

Commonly known as the "Beneficial Ownership Rule," the Final Rule requires banks to:

- Identify the beneficial owners of all new bank accounts that aren't personal or exempt accounts.
- Identify entities that have common beneficial owners and determine how common ownership affects the bank's BSA risk profile.
- Establish a system that actively searches for unusual transactions. When such transactions are identified, the bank must contact the account holder to verify that its beneficial owner's list is current.

Account holders are considered beneficial owners if they:

- Own at least 25 percent of a company's equity interests (either directly or indirectly).
- Are responsible for controlling, managing, or directing the company, e.g., if their job title is CEO, CFO, COO, president, or vice president.

For new accounts, account holders must provide documents proving their address, birth date, and Social Security number.

The Final Rule adds CDD to the traditional four pillars of a bank's effective anti-money laundering (AML) program. The other pillars are as follows:

1. Having a system of internal controls
2. Designating an AML/BSA compliance officer
3. Training employees in AML/BSA
4. Testing and auditing for AML/BSA compliance

This fifth pillar requires banks to develop a customer risk profile, conduct ongoing monitoring, and maintain customer information.

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