90 Day Note

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Ag Lending Considerations in 2020

By: Robert Viering, Director of Lending

On January 28, 2020, the FDIC published Financial Institution Letter (FIL-5-2020) *Advisory: Prudent Management of Agricultural Lending During Economic Cycles.* It's a good summary of many items to consider in the management of your ag portfolio and I recommend you taking a few minutes to read it.

In our loan review practice we have many clients that have a reasonable exposure to agriculture, including agribusiness. We've seen a decline in the cash flow generated by these borrowers as the ag sector declined from the historic highs of a few years ago. Over the last two years, we have seen this sector stabilize as most producers have been able to make adjustments to their operation and, while not back to the same levels of profitability, reach a level of acceptable cash flow. For many it has been a case of reducing expenses not only for crop inputs, but also cutting family living. For some that were over-leveraged, we have seen the sale of land (or sale-leaseback) that has brought debt service in line with today's cash flow or a slowing of capital expenditures. We've seen many instances where debt was refinanced to a longer term to bring payments in line with cash flow. However, even with the vast majority of borrowers making adjustments, we have seen more classified ag credits and increased non-performing loans. This has typically been due to high leverage or not being able to make the tough decisions needed to operate successfully today. Management skills are near the top of the list for success in agriculture today.

Based on what we have seen in our reviews of our ag clients and our own experience managing ag portfolios, the following is our list of "best practices" for 2020:

- Have all the information needed to make an informed credit decision at renewal, including:
  - **A complete financial statement with detailed schedules.** Take the time to review this with your borrower and ask if they have any other bills, such as payables to input providers or loans from family or friends.
    - For more complex borrowers that may have various partnerships or corporate entities that make up the farming operation, make sure you have financial information for each of the entities, not just the one you may be financing. You need a global financial statement, as well as a global cash flow.
    - Ask about actual ownership of assets. Some assets may be owned by a trust; if so, consider making the trust a co-borrower or guarantor.
    - Have your borrower complete the financial statement as of 12/31 each year. You'll need this to make accurate accrual adjustments when used with the tax return.
  - **A credit report on all individuals that sign personally.** Use this report to check for levels of personal debt and compare this report to past years to see if personal debt is increasing or decreasing.
  - **A new UCC search.** Use this to see if there are other secured lenders.
  - **Estimated Costs.** If you are getting a cash flow from the borrower to support an operating line, compare the estimated costs to historical costs. We see a lot of borrowers that underestimate their actual costs.
    - Government payments have been a big part of some farms' cash flow. It

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Portfolio Stress Testing

For information on
Young & Associates, Inc.'s
Portfolio Stress Testing Service,
click here.

is important to understand the impact of those payments on an operation. Consider what happens if the Market Facilitation Program is not extended in 2020.

- Obtain a basic stress test on the borrower's cash flow. If small changes in revenue or expenses will bring cash flow below break-even, do understand the level of crop insurance, any hedging program, and have a "Plan B" discussed with those in the operation regarding how they will get through if things are tough. It's a lot easier to have that conversation about selling some land now than when payments are due in the fall if things don't go as planned.

- **Cash Flow for New Debt Structure.** If you're going to restructure debt, make sure the operation can cash flow the new debt structure. If it can, great; you probably have a pass loan (or will be soon). If not, then you probably have a classified loan.
- **Trends.** Trends matter. What direction are leverage, liquidity, and cash flow going?
- **Working Capital.** Working capital is your real secondary source of repayment. If working capital is strong, that will cover an off year and not require a restructure or asset sale.
- **Future Plans.** Ask about the plans for 2020, including any capital expenditures (for your good borrowers, don't forget to pre-approve them for these loans); their marketing plans; and any changes in expenses from the prior year.

- Know your portfolio:
  - **Track risk rating changes for the portfolio.** What is the direction of your average risk rating?
  - **Stress test your portfolio.** Develop moderate and high stress scenarios. Stress revenue, expenses, and collateral values. Understand the impact of moderate and high stress on your capital. (Young & Associates, Inc. can work with you to provide a stress test of your ag or CRE portfolio.)
- Be proactive:
  - **Don't put off those farm visits.** You'll learn far more about your borrowers' operation, their concerns, and what they most enjoy by spending a few hours with them at the farm than you ever will just talking in your office, making phone calls, and sending emails or text messages. Document those visits and take pictures for the file. Some banks list all farms they need to visit, estimate when the visit will take place, and track their progress each month.
  - **Ask your borrower what information they monitor to manage the farm.** You'd be surprised how many operators have a lot more information than they share with you. It's almost never that they are holding information back as much as it is we haven't asked.
  - **Develop an exit plan if needed.** If you have a struggling operation and there doesn't appear to be a good way to turn it around, you need to have that tough conversation with the borrower about how you will get repaid sooner rather than later. Having a well-planned, cooperative exit plan is almost always in everyone's best interest.
- Know that best practices are not for every borrower:
  - Having more information than less is always best, but sometimes we have those very strong, long-time borrowers that provide minimal information. If every indication says the operation is strong, then sometimes you can get by with more limited information. But, in those cases, spell out in your loan presentation what you are not getting and why that does not pose a risk to the bank.

Need Assistance?

Please feel free to reach out to us if we can help you with your loan review, stress testing, or other aspects of your lending operation that you'd like to improve. Our lending team is made up of well-experienced bankers that provide you with realistic solutions. For more information, you can contact me at bviering@younginc.com or 330.422.3476. ❑

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CRE Portfolio Stress Testing

CRE Stress Testing is widely viewed by bankers and bank regulators as a valuable risk management tool that will assist management and the board of directors with its efforts to effectively identify, measure, monitor, and control risk. The information provided by this exercise should be considered in the bank's strategic and capital planning efforts, concentration risk monitoring and limit setting, and in decisions about the bank's loan product design and underwriting standards.

Young & Associates, Inc. offers CRE Portfolio Stress Testing that provides an insightful and efficient stress testing solution that doesn't just simply arrive at an estimate of potential credit losses under stressed scenarios, but provides a multiple page report with a discussion and summary of the bank's level and direction of credit risk, to be used for strategic and capital planning exercises and credit risk management activities.

Our CRE Stress Testing service is performed remotely with your data, allowing for management to remain free to work on the many other initiatives that require attention, while we make use of our existing systems and expertise.

For more information, contact Kyle Curtis, Director of Lending Services, at kcurtis@younginc.com or 330.422.3445. ❑

Liquidity Risk Management

By: Martina Dowidchuk, Director of Management Services and Senior Consultant

Does your liquidity management meet the standards of increased regulatory scrutiny?

What was once deemed acceptable is gradually coming under a more rigid review, and financial institutions need to be prepared to show that their liquidity risk oversight complies with both supervisory guidance and sound industry practices.

The liquidity risk may not be among the areas of community banks' immediate concern given the abundance of liquidity in the banking industry today. However, the history shows that liquidity reserves can change quickly and the changes may occur outside of management's control. A bank's liquidity position may be adequate under certain operating environments, yet be insufficient under adverse environments. Adequate liquidity governance is considered as important as the bank's liquidity position. While the sophistication of the liquidity measurement tools varies with the bank's complexity and risk profiles, all institutions are expected to have a formal liquidity policy and contingency funding plan that are supported by liquidity cash flow forecast, projected liquidity position analysis, stress testing, and dynamic liquidity metrics customized to match the bank's balance sheets.

Some of the common liquidity risk management pitfalls found during annual independent reviews include:

Cash Flow Plan:

- Lack of projected cash flow analysis
- Inconsistencies between liquidity cash flow assumptions and the strategic plan/budget
- Lack of documentation supporting liquidity plan assumptions
- Overdependence on outdated, static liquidity ratios and lack of forward-looking metrics
- Lack of back-testing of the model

Stress Scenarios:

- Stress-testing of projected cash flows not performed

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- Stress tests focusing on a single stress event rather than a combination of stress factors
- Stress tests lacking the assessment of a liquidity crisis impact on contingent funding sources
- Insufficient severity of stress tests

Contingency Funding Plan Document:

- Contingency funding plan failing to address certain key components, such as the identification of early warning indicators, alternative funding sources, crisis management team, and action plan details
- Lack of metrics defined to assess the adequacy of primary and contingent funding sources in the baseline and stressed scenarios

Liquidity Policy:

- Inadequate risk limits or lack of acceptable levels of funding concentrations defined in the liquidity policy
- Liquidity policy failing to address responsibilities for maintenance of the cash flow model, model documentation, periodic assumption review, and model validation

Management Oversight:

- ALCO discussions related to liquidity management not containing sufficient detail and not reflected appropriately in the ALCO meeting minutes
- Lack of periodic testing of the stand-by funding lines
- Lack of liquidity model assumption review or documentation of such review
- Lack of periodic independent reviews of the liquidity risk management process

If you are interested in an independent review of your existing liquidity program and a model validation, or are looking for an assistance with developing a contingency funding plan, liquidity cash flow plan, and liquidity stress testing, please contact me at 330.422.3449 or mdowidchuk@younginc.com. Young & Associates, Inc. offers an array of liquidity products and services that can help you to ensure compliance with the latest regulatory expectations. ❑

IRR and Liquidity Risk Review

Model Back-Testing / Validation of Measurements

Effective risk control requires conducting periodic independent reviews of the risk management process and validation of the risk measurement systems to ensure their integrity, accuracy, and reasonableness. To meet the requirements of the Joint Policy Statement on Interest Rate Risk (IRR), as well as the Interagency Guidance on Funding and Liquidity Risk Management and the subsequent regulatory guidance, Young & Associates, Inc. can assist you in assessing the following:

- The adequacy of the bank's internal control system
- Personnel's compliance with the bank's internal control system
- The appropriateness of the bank's risk measurement system
- The accuracy and completeness of the data inputs
- The reasonableness and validity of scenarios used in the risk measurement system
- The reasonableness and validity of assumptions

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- The validity of the risk measurement calculations within the risk measurement system, including back-testing of the actual results versus forecasted results and an analysis of various variance sources

Our detailed interest rate risk review reports and liquidity risk review reports assess each of the above, describe the findings, provide suggestions for any corrective actions, and include recommendations for improving the quality of the bank's risk management systems, and their compliance with the regulatory guidance. We are happy to customize the review scope to your bank's specific needs.

For more information, contact Martina Dowidchuk at mdowidchuk@younginc.com or 330-422-3449. ❑

Assessing your Compliance Training

By: Bill Elliott, CRCM, Director of Compliance Education

Last fall, the Consumer Financial Protection Bureau (CFPB) updated their Regulatory Agenda for the next few months. As has been the reality for a while, there does not seem to be any particular rush to accomplish many final rules. The Economic Growth, Regulatory Relief and Consumer Protection Act (EGRRCP Act) was signed into law in May 2018. In that law, there are a number of required changes that should be fairly easy to implement – if the CFPB would just do so. But in the short term, there appears little likelihood that the changes dictated by the law (or many other changes) will be placed into regulation. But change is still in our future – it is just a question of the timing.

". . . regardless of how confusing the regulatory process is, banks still have to comply . . . failure to train, especially when things are in flux, opens the bank regulatory scrutiny and/or fines for non-compliance."

Part of the problem is the regulatory process. Although all banks are not subject to the Home Mortgage Disclosure Act, it is an excellent example. The "new version" of Regulation C was published as a final rule, effective January 2018. Before the 2018 date, the CFPB changed the regulation. With the passage of the EFRRCP Act, many of the new required fields were eliminated for smaller reporters. Although a fairly simple series of changes were necessary, many months passed before the regulation was updated (October 2019). And when those changes were made final, there were still some outstanding issues in HMDA that needed to be addressed, and remain open at this writing. So even with all the changes, it is not "final" yet. The latest Small Entity Guide for HMDA (which will have to be modified again) is Version 4.

This complicates the life of any bank, regardless of size. When the regulatory process is poor and disjointed, it makes training and implementation more difficult. But the reality is that regardless of how confusing the regulatory process is, banks still have to comply.

Training is a necessary expense, as a failure to train, especially when things are in flux, opens the bank to regulatory scrutiny and/or fines for non-compliance. And keeping your policies and procedures current with the latest changes is always a challenge.

Banks should assess how information is disseminated throughout the bank as these changes occur to assure that training dollars are spent effectively. And the time to assess is now, while things are relatively "calm." Many banks have delegated training to electronic or web-based systems, and there are many good choices available. But, because of the nature of this type of training, they focus on the facts and requirements, but usually do not include information on what to expect of your employees, or the implementation strategies of your bank. Be wary of buying a training system and then assuming all your training needs are met.

We do not market electronic or web-based systems. But Young & Associates, Inc. offers a wide variety of personalized training opportunities, including:

- Live seminars with some of our state association partners
- Live in-bank training
- Conference calls
- Private webinars

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- *Virtual Compliance Consultant* program, which includes a monthly telephone call that can be used for compliance support and/or training sessions as well as policy support, and any other personalized training that you may need

In this period of relative quiet, take this time to assess your training methods and your training needs for the future. Eventually the regulators will begin to issue more regulation, and Young & Associates, Inc. stands ready to assist. To discuss how we can help, please contact Karen Clower at 330.422.3444 or kclower@younginc.com. ❑

Job Grades . . . For You?

By: Mike Lehr, Human Resources Consultant

Are job grades for you? “Yes,” is the short answer. The challenge is coming up with ones that fit your bank and don’t break the bank.

First, as a Federal contractor, banks must abide by the Pay Transparency Nondiscrimination Provision. This means employees can discuss their pay with other employees. Moreover, banks must post notifications stating as such. Employees will compare and assess positions accordingly.

Second, what to pay an employee is a tough question. Competitive pressures and meeting managers’ needs make this very subjective and inconsistent when hiring and promoting. Is the pay increase in line with the increase in responsibility? Are managers seeing this the same way? How well do officer titles relate to positions?

"When it comes to community banking, defining jobs is like driving an all-terrain vehicle . . . it’s highly variable compared to the big guys.”

Third, what are the career paths in your bank? How do different jobs rank? Is the move upward, lateral, or downward? When is a finance officer on par with a commercial lender? Should an increase in title come with a different job? In all banks, positions come with different statuses. Employees’ and managements’ views don’t always sync on this.

Finally, community banks differ from regional and national ones. They differ from other federal contractors who are typically much larger. At those places, jobs have very specific descriptions. At community banks, a job could contain the responsibilities of three different jobs as those places. Moreover, they change. It’s not unusual for employees to trade job duties.

Yes, job grades can solve these problems and answer these questions. The problem is that the job grading industry is armed with fancy calculations and formulas to create them. Here, think cost. They follow a recipe, the same one no matter the size of the project.

Of course, they “customize” in the end after they burn hours running through the numbers. It’s like applying a six-sigma process to a two-sigma project, using that preverbal sledge hammer to kill a flea, or buying a Ferrari to arrive quicker when the road is rough and breaking fifty safely isn’t possible.

Also, speaking of rough roads, finely tuned calculations and formulas work best on clearly defined jobs. When it comes to community banking, defining jobs is like driving an all-terrain vehicle. It depends on the needs and talent on hand. It’s highly variable compared to the big guys.

So, that brings us to the point about job grades. You can do it. Yes, training helps. You might even have it now. Remember, the process they teach is a recipe, not a concept. Following it blindly will waste time and yield bad results. Do the parts that only make sense and return high value. Improvise, too – it’s all right.

Lastly, these guides apply too if you hire out for part or all of the effort. Pay for value. People modify recipes all the time. That’s why the phrase “to taste” is in them.

Regardless, think all-terrain vehicle. Job grades can solve a variety of compensation, career-pathing, employee engagement, and officer-titling problems. It’s also insurance against pay discrimination.

For more insights and guidance on how to get your employees to make better decisions, you can reach Mike Lehr at mlehr@younginc.com. ❑

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Pandemic Policy (#253) – $195

The coronavirus continues to spread across the globe, resulting in increased travel restrictions, as well as screening at major airports in the United States. The CDC has warned that it is not a question of if the coronavirus will spread within the U.S., but when.

The World Health Organization (WHO) has declared the virus a global public health emergency. Both the FFIEC and WHO have issued guidance on steps to be taken in developing a pandemic policy and plan. Unlike traditional business continuity planning that plans for destruction or impairment of buildings and equipment, pandemic planning must address staffing shortages and other human elements of the business. Traditional business continuity plans typically plan for disruptions of one to two weeks, rather than disruptions lasting for several months which could occur during a pandemic.

You should review your institution's pandemic plan to ensure that it is up to date should the virus spread and cause a pandemic in the U.S. This policy may be used as a stand-alone policy or incorporated into your institution's business continuity policy and contains guidance from The Interagency Statement on Pandemic Planning.

Liquidity Toolkit (#273) – $1,250

Includes:

- **Liquidity Cash Flow Planning Model (#271):** Forecast funding sources, funding needs, and cash flow gaps. Monitor availability of contingent liquidity. Monitor funding concentrations and dynamic cash flow ratios. Perform liquidity stress testing and multiple-scenario what-if analyses. (*regularly $950*)
- **Liquidity Contingency Funding Plan (#272):** Delineates strategies and actions addressing potential liquidity shortfalls in emergency situations. Includes identification of stress events, stress levels, early warning indicators, parameters for liquidity stress testing, sources of funds and funding strategies, lines of responsibility and communication, as well as a detailed crisis action plan. (*regularly $275*)
- **Liquidity Management Policy (#096):** Customizable policy designed to ensure that the bank is managed to provide an adequate level of liquidity to meet both predicted and unexpected cash needs while maintaining a planned net interest margin. (*regularly $225*)

System Requirements: Microsoft® Word 2007 and Excel 2007 or higher

Save $200 when you purchase the Liquidity Toolkit.

Capital Planning System

Assess capital adequacy in relation to your bank's overall risk and develop a customized capital plan for maintaining appropriate capital levels in all economic environments.

The latest update addresses the new Community Bank Leverage Ratio (CBLR) framework recently adopted by the federal banking agencies. The final CBLR rule applies to depository institutions that have less than $10 billion in total assets and meet other qualifying criteria, including a tier 1 leverage ratio of greater than 9 percent.

Allows you to:

Develop a base case scenario in which minimum capital adequacy standards are established.

Identify and evaluate risk for your bank. Parameters in this analysis have been field-tested in our work with banks over the years and closely resemble adequacy standards established in consent orders.

Stress test capital by loan classification (as recommended by the FDIC and OCC).

Perform contingency planning for stressed events. All assumptions are stressed to determine the amount of capital needed and possibilities for increasing capital are examined.

Generate your capital plan in as little as 1 day. Data from the Microsoft® Excel spreadsheets can be easily transferred directly into a Word document that can be customized to fit the unique circumstances at your bank.

First Year License Fee (#304) – $1,095

Update/Annual License (#306) – $495

System Requirements: Microsoft® Excel 2007 or higher

Customizable Bank Policies

Young & Associates, Inc. has developed over 95 practical bank policies designed specifically for community banks that will ease the burden of developing bank policies from scratch.

- **Pandemic (#253) – $195**
- **Marijuana/Cannabis and MRB (#331) – $395**
- **Flood Insurance (#123) – $225**
- **Bank Secrecy and Anti-Money Laundering (#109) – $350**
- **Cybersecurity (#313) – $195**
- **Complete List of Available Policies –** over 95 management, lending, and compliance topics