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Mueller Prost
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# Financial Lending Notes

A Newsletter for Commercial Lenders

Spring 2018

*The Tax Cuts and Jobs Act*

## How Might Tax Reform Affect Community Banks?

**In December, Congress passed and** President Trump signed into law the biggest tax reform measure in more than 30 years: the Tax Cuts and Jobs Act (TCJA). The legislation contains a number of provisions that will be helpful to consumers and businesses.

With the uncertainty presented by the prospects of tax reform now behind us, many businesses can move forward with growth and expansion plans that have been on the back burner. This could lead to increased business borrowing which, of course, would be good news for community banks.

### Beneficial Depreciation Provisions

Among the most significant TCJA provisions are the ones affecting the depreciation of business equipment. These provisions are designed to accelerate business investment, boost productivity, and strengthen economic growth and job creation.

The legislation doubles bonus depreciation to 100% for assets acquired and placed in service between September 27, 2017 and December 31, 2022. In addition, bonus depreciation now applies to both new and used equipment—previously it only applied to new equipment.

A wide range of business assets qualify for 100% bonus depreciation. In addition to machinery and equipment, they also include computer and telecommunication systems, office furniture, business vehicles, computer software, and qualified TV and film productions.

Bonus depreciation will be scaled back starting in 2023 as follows before disappearing in 2027:

- 80% in 2023
- 60% in 2024
- 40% in 2025
- 20% in 2026

Another beneficial depreciation provision of tax reform is a permanent increase in the Section 179 expensing limit. In 2018, this limit is increasing from $510,000 to $1 million, and it will be indexed for inflation in future years. And the expensing phase-out threshold is being increased from $2 million to $2.5 million this year, also to be indexed for inflation going forward.

Section 179 expensing allows businesses to deduct the cost of qualifying depreciable property (both new and used) and software during the first year, up to the threshold. Qualifying real property improvement costs are also generally eligible for Section 179 expensing. Improvements to the interior of retail buildings, non-leased residential buildings, and certain restaurant buildings generally qualify.

### Lower Corporate Tax Rates

One of the centerpieces of the TCJA is a permanent reduction in the top corporate income tax rate from 35% to a 21% flat rate, starting this year. The 20% corporate Alternative Minimum Tax (AMT) is also repealed effective this year.

And the legislation adds a new tax break for owners of pass-through entities like partnerships, S corporations,

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2 Risks for Community Banks
3 Effects of Tax Reform
4 Exceptions and Variances

*The OCC's Semiannual Risk Perspective*

# Community Banks Face Strategic Risk in 2018

**The current operating environment** of the U.S. banking system presents community banks with a high level of "strategic risk," according to the most recent Semiannual Risk Perspective published in January by the Office of the Comptroller of the Currency (OCC) National Risk Committee (NRC).

Given this, the report urges banks to be especially vigilant in case the economy weakens or markets suddenly tighten.

## Banks in Good Health …

The report, which is based on data as of June 30, 2017, paints a positive picture of the financial health of U.S. banks. For example, capital and liquidity have improved tremendously since the financial crisis and are near historic highs. Return on equity, net income, net interest income, and net interest margins all improved during the first half of 2017 compared to a year earlier.

And while bank loan growth slowed overall during the period measured, it remained stable for smaller banks, which the NRC defines as banks with total assets of less than $1 billion.

Based on this data, the report concludes that the banking sector remains "relatively stable" with strong asset quality and satisfactory underwriting policies and procedures. However, the volume of loans with eased terms or structures is increasing due to growing competition. Weaker underwriting heightens the risk of credit quality problems if and when economic conditions deteriorate, notes the report.

## … But Ongoing Concerns Persist

The NRC voices ongoing concerns about strategic risk due to a number of factors. These include competitive pressure to boost lending, enhance efficiencies, embrace new technologies, and introduce innovative products and services.

In particular, the credit environment continues to be influenced by aggressive competition (especially from non-bank lenders), heightened asset valuations, slowing loan growth, and tighter spreads. "These factors are driving incremental easing in underwriting practices and increasing concentrations in select loan portfolios," states the report.

It specifically voices concerns about potential lender complacency due to the long economic recovery and expansion. "In this environment, lenders need to focus on maintaining sound credit standards within risk tolerances and understanding the potential credit risks that may be exposed under less-benign economic conditions," the report states.

## Operational and Compliance Risk

Banks also continue to face operational risk due to the increasing complexity of cybersecurity threats and the growing use of third-party service providers for some critical operations. And compliance risk remains elevated due to growing money laundering threats, challenges in complying with Bank Secrecy Act (BSA) requirements, and complexity in consumer compliance regulations.

In addition to the credit, operational, and compliance risks noted previously, the NRC monitors a variety of other risks that it believes bankers should be aware of, including the following:

- Weaknesses in the governance of product sales, delivery, and service may further increase operational risk.
- Increasing concentrations of commercial real estate (CRE) loans highlight the need for sound risk management processes, including concentration risk management.
- The potential for renewed price declines for grain crops, livestock, and dairy may compound the declining prices of the past few years, thus increasing agriculture borrowers' debt and their ability to service this debt.
- New requirements under the amended regulation implementing the Military Lending Act (MLA)—as well as changes to the data collection and processing rules for the Home Mortgage Disclosure Act (HMDA)—may present further challenges to banks' compliance management processes.
- The current expected credit losses (CECL) standard—for which implementation begins in 2020—may pose operational and strategic risk to some banks when it comes to measuring and assessing the collectability of financial assets.

## A "Normal" Rate Environment?

Also keep in mind that rising interest rates could adversely impact the asset quality and earnings of community banks with a concentration in longer term fixed-rate assets. The risk is compounded by a whole generation of lenders who believe the interest rate environment of last 10 to 20 years is "normal."

The NRC publishes the Semiannual Risk Perspective twice each year, using data gathered midyear and at year end. You can download the complete report by visiting https://www.occ.treas.gov and typing "Semiannual Risk Perspective" in the search box.

# Effects of Tax Reform

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and LLCs. For tax years 2018 through 2025, these owners can deduct up to 20% of qualified business income. Due to this new tax break and other tax reform provisions, the top tax rate for pass-through entities has fallen from 39.6% to 29.6%.

Some analysts have speculated that commercial banks could benefit more than most industries from these lower tax rates. Because banks don't make big investments in capital and equipment and other tax preference items and can't shift their earnings overseas, a larger percentage of bank earnings are subject to income taxes.

### Higher Consumer Spending

Tax reform also lowered individual tax rates and nearly doubled the standard deduction. The top individual tax rate is now 37%, compared to 39.6% before tax reform, and the standard deduction for married couples filing jointly has been increased from $12,700 to $24,000 this year.

The Tax Policy Center has estimated that 90 percent of middle-class American families will receive an average tax cut of about $1,600 a year, starting this year. This essentially serves as a cash infusion for the U.S. economy, which many analysts believe will result in higher consumer spending—the biggest component of economic growth.

As consumers spend more money, many businesses will need to increase their investment in accounts receivable and inventory to meet higher demand and growing sales. This will often require them to take out term loans, lines of credit, and asset-based loans for working capital and to purchase additional plant and equipment.

### Repatriation of Overseas Assets

Finally, the legislation will allow international businesses to move cash assets currently being held overseas into the U.S. at a 15.5% one-time repatriation rate, or 8% rate for non-cash assets. This will add more money to these businesses' coffers for investment here in the U.S., which may also stimulate additional business borrowing.

### Start Planning Now

All of these beneficial tax reform provisions are effective now, so businesses should start reaping the benefits very quickly. This makes now a good time to plan strategically for how your bank can be prepared to help meet the growing financing needs of your small business customers.

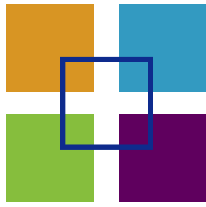
*Give us a call if you'd like to discuss these and other provisions of tax reform in more detail.*

## A Financial Windfall for Banks?

Many community banks could enjoy a financial windfall this year due to the lower corporate income tax rates enacted by the Tax Cuts and Jobs Act.

If yours is one of them, what should you do with the money? Your options:

1. Hold onto the money as retained earnings, and use it to support growth.
2. Raise employees' wages and benefits and/or pay out employee bonuses.
3. Make special distributions to shareholders in the form of dividends or stock buybacks.
4. Lower loan interest rates.
5. Raise deposit interest rates.



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## Are You Tracking Exceptions and Variances?

**It's not uncommon for bankers to** make exceptions to policies and variances to procedures. But issues can arise when banks don't distinguish between exceptions and variances and track them regularly.

Procedures guide the processes bankers use to underwrite and approve loans. They include maximum loan amounts, financial statement requirements, and ratios like debt service coverage and loan-to-value. Variances from procedures should require approval from the next highest management level up from the commercial lender.

Policies are rules regarding what your bank will and won't do in commercial lending. For example, your policy might state that you won't make loans outside of your defined market area or to businesses in certain industries. Therefore, exceptions should be rare and require a higher level of bank approval.

You should track exception and variance approval on a regular basis—at least quarterly, if not monthly—have the credit administration review them, and report them to the board. The report should answer the following:

- How many and what types of exceptions and variances occur?
- Are they typically among certain types of loans or certain markets?
- Are certain lenders making all or most of the exceptions and variances?

By tracking and reporting exceptions and variances, you can spot trends of potential issues. For example, do you have a rogue lender who needs reigned in? Do you need to train your lenders about bank policies and procedures and when exceptions and variances are appropriate?

Perhaps most importantly, tracking and reporting provides the data needed to determine if the current level of exceptions and variances is acceptable. If not, you may want to consider tightening your underwriting standards, limiting exceptions/variances, or changing your exception and variance guidelines.

*Contact us if you have more questions about reporting for exceptions and variances.*

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