SALTMARSH BANKTALK 2020

COMPLIANCE FUNNEL 2020:
Lender beware

NELSON MULLINS

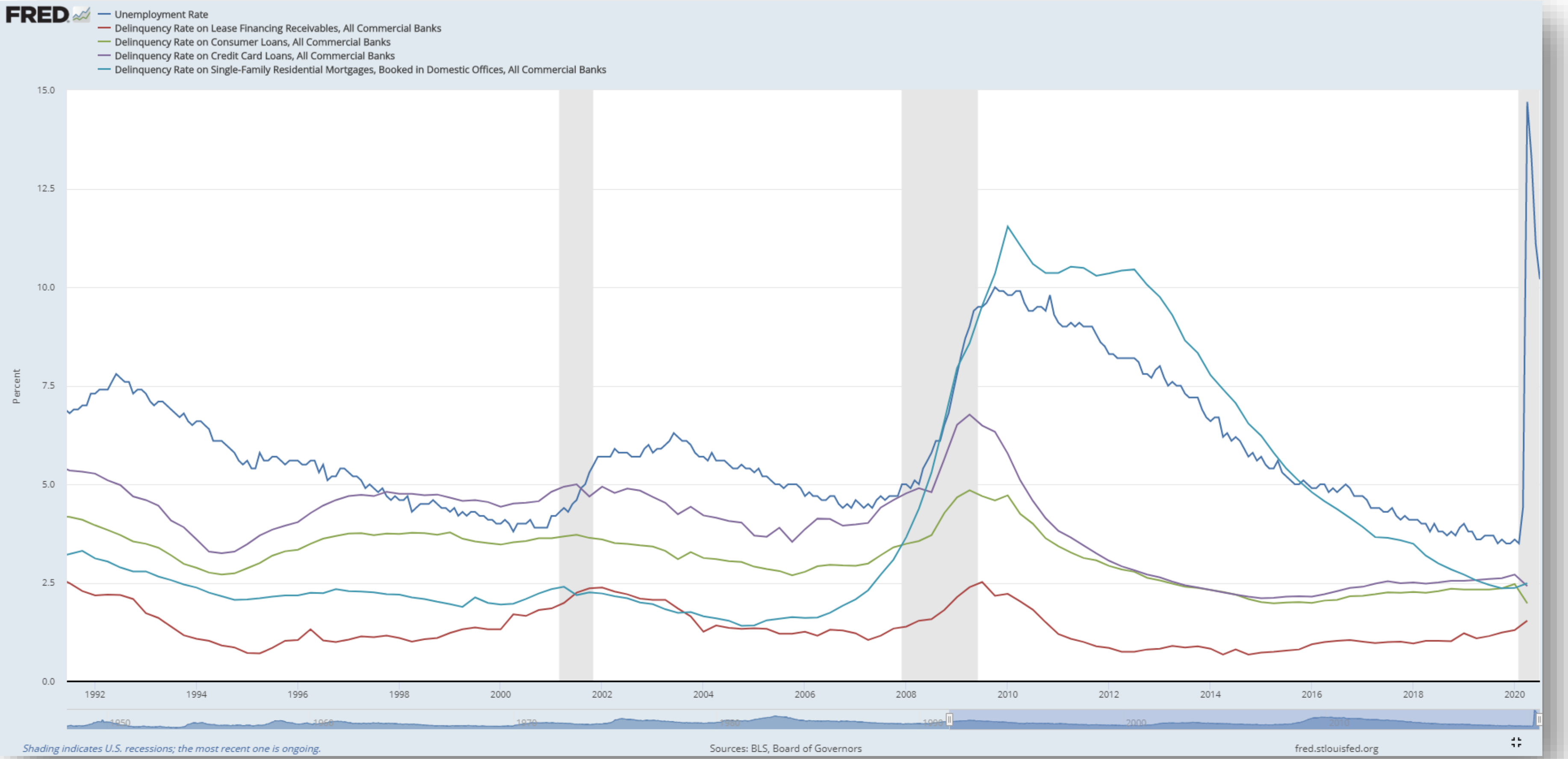
TODAY'S PRESENTATION:

In the wake of COVID-19, financial institutions face numerous challenges responding to customer and member needs. With this flexibility and new product offerings come additional compliance risks:

1. Preparing for New Challenges—Defaults and Lessons Learned from 2007
2. Paycheck Protection Program Regulatory Challenges and Lawsuits
3. Maximizing CRA Credit
4. Assessment of Compliance Systems, Disaster Recovery, and Strategic Plans

NEW CHALLENGES: PREPPING FOR DEFAULT

Federal Reserve data continues to look positive, even in light of the unemployment spike. However, this may be a trailing index as numerous industry groups are reporting significant spikes in delinquency and “financial hardship” modifications.



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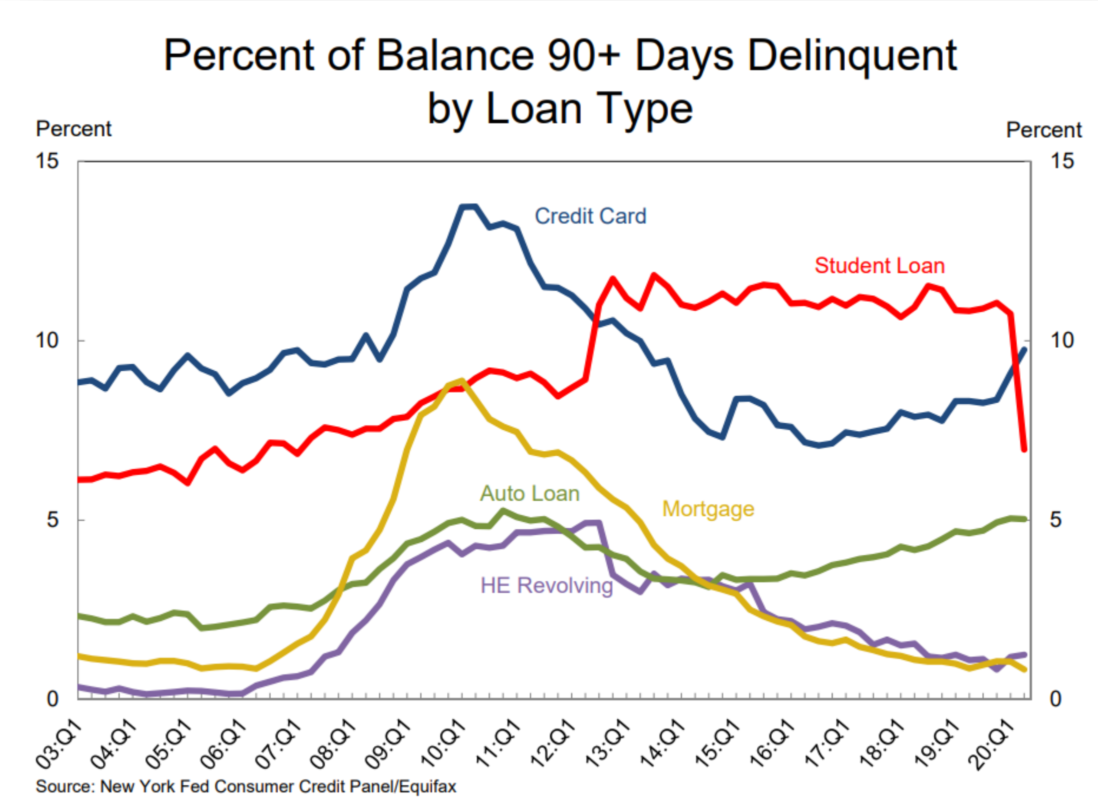
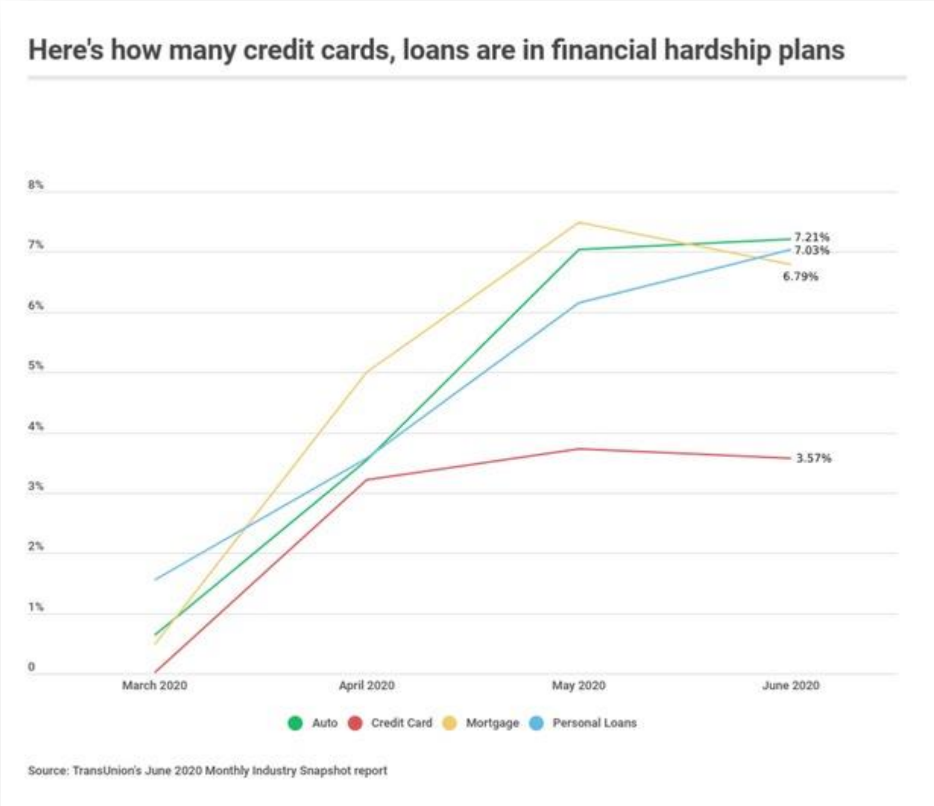
THE DEFAULT WAVE MAY BE COMING

Though defaults continue to hold steady, many of these credits do not “show” on these reports as they are in forbearance or otherwise operating under hardship plans.





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THE NEED TO DOCUMENT: AVOIDING TDR CLASSIFICATION

Generally, modifications in loan terms related to COVID-19 will not automatically result in Troubled Debt Restructurings (TDRs). As set forth in the FDIC FAQs (May 27, 2020) and under Section 4013 of the CARES Act, banks may elect not to categorize loan modifications as TDRs if they are:

1. related to COVID-19;
2. executed on a loan that was not more than 30 days past due as of December 31, 2019; and
3. executed between March 1, 2020, and the earlier of (A) 60 days after the date of termination of the National Emergency or (B) December 31, 2020.

Management should be closely reviewing loan processes and procedures so that the institution can demonstrate to examiners the "prudency" of underwriting standards and how any loan accommodation programs are ultimately structured with a view toward loan repayment. Loan committees should focus on clear documentation so that decisions are not "second-guessed."

LESSONS LEARNED FROM 2007

Avoid unexpected financial shocks by closely evaluating key credits and deposit relationships for the impact on the institution and any leading risk indicators.

Update financial information on key credits to understand any potential risks.

<u>Avoid the lessons learned from the recession</u>:

- Avoid potential lender liability claims;
- Increase training;
- Train employees that compliance is more important in a default environment than at origination;
- Prepare employees for increased customer engagement and increased attempts to shift liability away from customers;
- Remember that fair lending and UDAAP applies to servicing, modifications, forbearance, and collections;
- Assume that loss mitigation programs and "waterfalls" will be subjected to fair lending analysis for potential disparate treatment;
- Remember that many banks struggled with helping to accommodate Limited English Proficiency ("LEP") borrowers during the last recession; and
- Provide resources for the employees—dollars saved now in compliance and training will come back ten-fold after examinations, in remediation programs, or in restrictions on the institution.

Carefully assess capital adequacy and liquidity management. As we are seeing, now may be a time to increase capital or liquidity proactively to weather future events.

Do not lose sight of strategic M&A opportunities. Many institutions expanded significantly during the last recession and grew aggressively from it.

PAYCHECK PROTECTION PROGRAM CHALLENGES: FAIR LENDING

*For those applicants with reportable demographic data compared to 2018 U.S. Census Bureau Annual Business Survey

Gender	Total Number	Percentage	U.S. Percentage
Female-Owned	18,701	14.69%	19.75%
Male-Owned	99,764	78.38%	60.6%
Unanswered	8,819	6.93%	19.65%

Race/Ethnicity	Total Number	Percentage	U.S. Percentage
Am. Indian/AK Native	551	0.43%	0.43%
Asian	7,139	5.61%	9.67%
Black/Afr.-Am.	1,827	1.44%	2.16%
Hispanic	6,201	4.87%	5.61%
Unanswered	111,565	87.65%	82.13%

Veteran Status	Total Number	Percentage	U.S. Percentage
Veteran-Owned	3,953	3.11%	6.11%
Non-Veteran-Owned	77,320	60.75%	86.49%
Unanswered	46,011	36.15%	7.40%

PAYCHECK PROTECTION PROGRAM CHALLENGES: SHIFTING REPUTATIONAL RISKS

We are already starting to see the tonal shift from PPP as a needed tool to triage a national emergency to PPP being framed as a tool for banks to generate fees and undeserved companies to receive a lifeline. This signals a potential lens through which regulatory supervision will take place:

- **CNBC (7.7.20)**: Billionaires, country clubs, private jet companies and Kanye West all received millions in government funding under the Paycheck Protection Program, according to filings.
- **Wall Street Journal (7.7.20)**: "Banks Could Get $24 Billion in Fees From PPP Loans": JPMorgan Chase & Co. and Bank of America Corp. are in line to split between $1.5 billion and $2.6 billion in fees for being the conduits of the government's aid program for small businesses stricken by the coronavirus shutdown.
- **American Banker (7.9.20):** Wells and other large banking companies such as JPMorgan Chase, Bank of America and Citigroup have said for months they will give away the processing fees generated by PPP loans after critics complained about lenders' profiting from the rescue program…..On Thursday, Wells Fargo announced the creation of the "Open for Business Fund" that will work with nonprofits across the country to provide capital, technical assistance and support aimed at long-term recovery and resiliency for small businesses, especially minority-owned ones.
- **Forbes (8.29.2020):** "On the relief funds, usually we say help the needy and deal with the greedy. Here the greedy have jumped straight to the head of the line."

PAYCHECK PROTECTION PROGRAM CHALLENGES: LITIGATION AND REGULATORY ACTIONS

Regulatory:

Fair Lending (ECOA / Reg B) Violations in Application Processing and Lending

Fair Lending (ECOA / Reg B) Violations in Forgiveness Programs

Agent Disclosures / False Claims Act Violations

CRA / LMI Lending (they can count)

Lawsuits:

Eligibility Restrictions

Loan Prioritization / Reordering

Agent Fees

Lender Liability for Forgiveness

PPP Loans Triggering Default Under Existing Debt

CRA CREDIT: RECOGNITION FOR RESPONSE EFFORTS

Immediate efforts to meet customers' cash and financial needs are generally not subject to examiner criticism. In addition, for 36 months after a disaster designation, an institution can receive CRA consideration for efforts to revitalize or stabilize a disaster area. So long as they are executed in a safe and sound manner, they can include:

- Waiving ATM fees for customers and non-customers
- Increasing ATM daily cash withdrawal limits
- Waiving overdraft fees
- Waiving early withdrawal penalties on time deposits
- Waiving availability restrictions on certain governmental or other checks
- Cashing government checks for those receiving federal/state benefits or stimulus
- Easing restrictions on cashing out-of-state and non-customer checks
- Easing credit card limits and credit terms for new loans
- Allowing loan customers to defer or skip some payments
- Waiving late fees for credit card and other loan balances
- Delaying the submission of delinquency notices to the credit bureaus
- Assisting with affordable housing and housing stability for LMI renters

DEPOSIT ACCOUNT ASSISTANCE

Given the financial hardship faced by customers and members, many financial institutions began to relax rules relating to deposit account fees or transaction limits. However, with this comes risk:

Equal Treatment: Were fee waivers, fee cancelations, or credit limit changes marketed, offered, and implemented on a fair, non-discriminatory basis?

CRA: Did you maintain records of efforts to help LMI communities and actively promote this relief to these communities? Did you keep records of your efforts?

Account Tying: Did any bankers suggest that certain services were only available if customers opened accounts?

BSA/AML: If your institution transitioned to online or mobile account opening, did you update BSA/AML/OFAC programs to reflect these new mechanisms? Did you adapt your policies and procedures to meet these new demands?

COMPLIANCE SYSTEMS, DISASTER RECOVERY, AND STRATEGIC PLANNING

Regulators will likely review your institution's strategic plan for 2020 and your disaster recovery plan. **Have you reviewed these and updated them to account for a post-COVID banking environment?**	Did it call for organic growth?
	Did it project rising defaults?
	Did it call for growth through M&A?
	Have you paused to update in response to COVID-19?
Are there any other "open" items in your regulatory and compliance pipeline?	Need to update policies and procedures for new product offerings?
	Need to update policies and procedures to account for new customer channels?
	Need to update policies and procedures on e-closings, e-notarization, and e-remote notarization?
	Need to develop policies and procedures for emergency programs: PPP, MSLP, etc.
	Need to update Compliance Management System (CMS) or Risk Assessments for changes brought on by COVID?

UPDATES TO RISK ASSESSMENTS AND PLANS

						ASSESSMENT OF FUTURE RISK		RISK TRENDS		CURRENT RISK TO BANK		RESULTING MITIGATION EFFECTIVENESS		INHERENT RISK			
Reference Number	Product Line	Risk Category	Risk Set	Risk Factor	Statute or Regulation	Bank's Resulting Exposure	Bank's Resulting Exposure	Trend in Exposure	Risk Trend	Residual Risk	Residual Risk	Mitigation Effectiveness	Mitigation Effectiveness	Inherent Risk	Inherent Risk	Likelihood Score	Impact Score
Legend	*Affected business line within the Bank*	*Law Set*	*Risk Set*	*Description of risk factor associated with product or service and applicable legal requirement(s).*	*Cross reference to statute, regulation, or guidance establishing risk factor*	*Bank's exposure taking into account Residual Risk and Tend in Exposure.*	*Residual Risk accounting for Risk Trend*	*Whether the risk to the bank is increasing, stable, or decreasing.*	*-0.5=Decreasing, 0=Stable, +0.5=Increasing*	*High, Moderately-High, Moderate, Low-Moderate, or Low*	*(Mitigation Effectiveness + Inherent Risk) / 2*	*Strong, Good, Fair, Needs Improvement, Weak/No Controls*	*Calculated Resulting Effectiveness: 1=Strong, 2=Good, 3=Fair, 4=Needs Improvement, 5=Weak/No Controls*	*High, Moderately-High, Moderate, Low-Moderate, or Low*	*(Likelihood Score + Impact Score) / 2*	*Based on transaction volume, regulatory emphasis, historic complaints, historic violations, and complexity*	*1=Incidental, 2=Minor, 3=Moderate, 4=Major, 5=Extreme*
1098	All	Compl. Mgt.	Compliance	Does the bank demonstrate a strong commitment to oversight of the compliance management system, including by: providing systems, capital, and human resources for compliance?		Moderately-High	3.5	Stable	0	Moderately-High	3.5	Fair	3	Moderately-High	4	4	4
1099	All	Compl. Mgt.	Compliance	Does the bank have processes and controls to ensure that employees are knowledgeable, empowered, and held accountable for compliance with consumer financial laws?		Low-Moderate	2.5	Stable	0	Low-Moderate	2.5	Strong	1	Moderately-High	4	4	4

Each of these Scores are Directly Impacted by the Current Pandemic

In addition, **your overall risk scoring and your risk prioritization** <u>should</u> change as a result of the COVID-19 pandemic.

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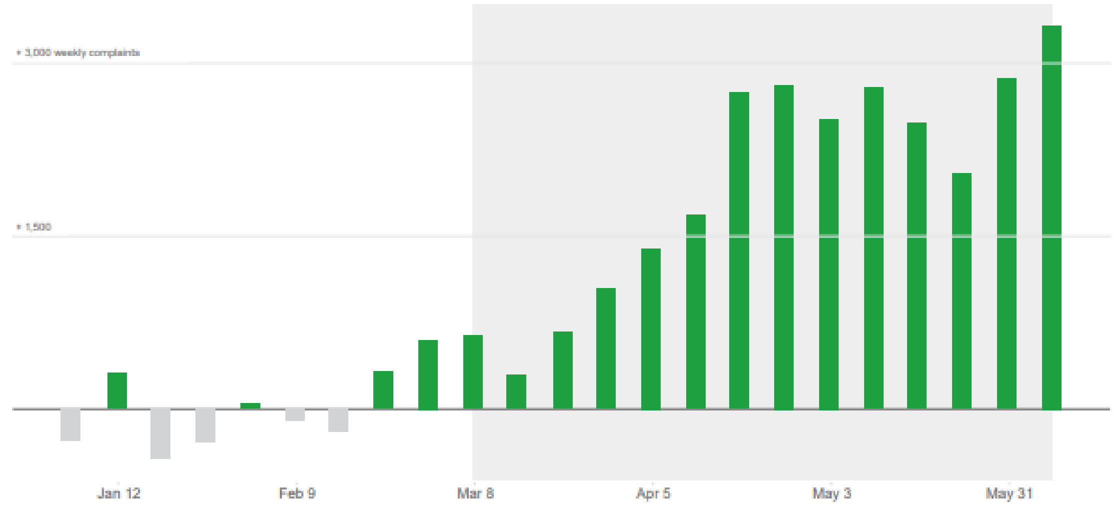
INCREASED REGULATORY SCRUTINY

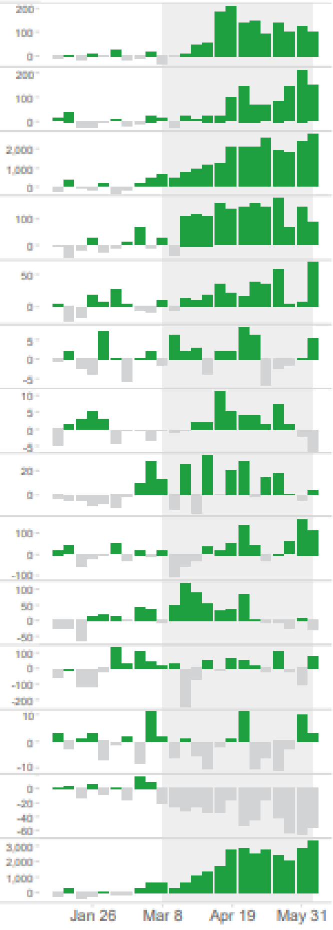
The CFPB has seen a significant increase in consumer complaints during the pandemic (July 2020 Report). With this will come increased regulatory scrutiny.

FIGURE 2: WEEKLY DIFFERENCE FROM BASELINE, JAN. 5, 2020 TO JUNE 13, 2020.



	Pct change (Post Mar 8 vs. baseline)	Baseline	Post Mar 8 weekly average	Difference
Prepaid card	105%	91	186	95
Money transfer or service, virtual currency	43%	169	241	72
Credit or consumer reporting	42%	3,842	5,470	1,627
Credit card	17%	629	738	109
Vehicle loan or lease	15%	154	177	23
Title loan	13%	12	13	1
Credit repair	13%	16	18	2
Personal loan	9%	89	98	8
Checking or savings	6%	525	556	30
Mortgage	5%	532	560	28
Debt collection	0%	1,484	1,481	-4
Payday loan	-5%	35	33	-2
Student loan	-24%	164	126	-39
Grand Total	**25%**	**7,750**	**9,698**	**1,948**

Weekly difference from baseline



INCREASED EXAMINER OVERSIGHT

Examiners will look for responsive management and board oversight:

- Decrease in the time between committee, management, or board meetings;
- Detailed minutes to reflect a focus on changing economic climate;
- Review of responses to changing impact of COVID-19 on the institution;
- Assessment of committees and whether appropriate subject matter expertise exists;

Focus on "active leadership" that is responsive to the crisis.

Remember the main goals of "safety and soundness." No examiner should see a continuation of routine oversight or routine reports/meetings.

Consider whether every board presentation should include highlights specific to the COVID-19 response and specific activities relating to the institution's response.

Consider whether to increase committee oversight by increasing the review of credits and material deposit relationships that may be impacted by COVID-19.