Q3 2020
BANK WATCH
QUARTERLY UPDATE ON LEGAL ISSUES IN BANKING

Special Assets / Loan Deferrals Offer Near-Term Relief but Losses May Loom

As a cautious U.S. returns to business operations in the third quarter of 2020, the banking industry faces many unknowns.

The Economic Forecast

The last ten years of expansion yielded growth for banks in a calm economic climate—resulting in less problem credits, less need for a robust special assets department, and lower loan loss provisions and reserves (LLRs).

Since the pandemic struck the U.S. in March, shuttering businesses and causing massive unemployment, the banking industry finds itself at a crossroads. Borrowers from both commercial and consumer sectors are now challenged to meet contractual loan obligations.

> **As a general rule, nearly all Virginia community banks were performing well as of the end of 2019.**

During 2019, key performance indicators such as Return on Assets (ROA) and Return on Equity (ROE) were healthy. Banks greater than $1B generated a 1.19% ROA on average and ROE of 9.23%, while the Virginia bank subset averaged 1.0% ROA and 9.73% ROE. (Source: FDIC)

If we look at data from the "great recession" of 2007-2009, many banks moved their loan loss provisions to a range between 2% and 2.5%. Peak unemployment hit 6.3% and GDP contraction was 5.1%. The banking industry experienced very large charge-offs for several years following this period.

The Atlanta Federal Reserve's real GDP estimate of GDPNow for Q2 2020 is –35.5% (quarterly percent change SAAR) as of July 9. The CBO forecasts unemployment to average 15% for the second and third quarter of 2020.

The question now at hand is how will banks pivot and manage the likely deterioration in asset quality and rise in problem credits? Will there be a rush to enlarge workout departments and hire expensive workout talent in a market where demand may outstrip supply?

Woods Rogers Special Assets Group

The banking attorneys and advisors at Woods Rogers created a Special Assets team to be an outsource partner for banks. This group offers banking and financial services counsel on an as-needed project basis.

Here are the banking areas that will need a closer look to plan for likely deterioration in asset quality and rise in problem credits:

Workouts Management and Forbearance Agreements

We have represented purchasers of distressed businesses in all stages of an acquisition in bankruptcy, from initial due diligence, negotiating and drafting transaction documents and procedural pleadings, to the final closing. We have represented private equity clients as well in acquisitions and workouts of distressed companies. We have also coordinated and managed real estate liens and forbearance agreements.

Credit Risk and Loan Documentation Review

Against the backdrop of an uncertain economy, managing credit risk is one of the most complex challenges for banks. Our attorneys and advisory staff have represented banks in commercial loan closings ranging in size from $1M to $75M. All of our work involves evaluation of credit risk and review of loan documents, often with numerous modifications and sometimes involving multiple parties. We have represented banks in traditional as well as hybrid financings.

Bankruptcy and Restructuring

Our attorneys have represented distressed borrowers, lenders, and other creditors in a variety of industries including distribution and logistics, energy, financial services, health care, manufacturing, retail, and technology. Our guidance includes solutions for restructuring transactions and loans both inside and outside of the bankruptcy process. One of the attorneys in this group is a Chapter 11 Subchapter V Trustee.

Visit woodsrogers.com/special-assets for more information.

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The Bank Watch report from the Woods Rogers Financial Services Practice Group is a quarterly review of regulatory and technology news affecting the financial services industry.

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FinCen Provides Regulatory Relief for Banking Hemp Businesses

The U.S. Department of Treasury Financial Crimes Enforcement Network (FinCen) issued guidance on June 29, 2020, clarifying Bank Secrecy Act (BSA)/Anti-Money Laundering requirements for financial institutions seeking to serve hemp businesses.

In particular, the guidance identifies the type of information and documentation that financial institutions can collect from a hemp business to comply with the law. The guidance is intended to increase the availability of financial services to hemp-related businesses. It removes the regulatory uncertainty that has persisted based on hemp as a marijuana product—an illegal substance under federal and state law.

The Agriculture Improvement Act of 2018 (the “Act”) removed hemp from the definition of marijuana in the Controlled Substances Act and directed the establishment of a regulatory framework for the legal production of hemp by the states. In response, the Virginia General Assembly enacted legislation in 2019 for the licensing and regulation of hemp activities.

What Information to Collect

In addition to the customer due diligence a financial institution conducts for all customers—including hemp businesses—the financial institution must confirm a grower’s compliance with state licensing laws. This confirmation is accomplished by obtaining (1) a written attestation by the hemp grower that it is validly licensed or (2) a copy of the license.

The guidance notes the extent to which a financial institution needs to seek additional information depends on the institution’s assessment of the risk posed by each customer. Additional information might include crop inspection or testing reports, license renewals, updated attestations, or correspondence from the state.

Furthermore, the guidance stresses the importance of understanding the nature of a hemp customer’s business. Doing so allows the development of a customer risk profile and assists in monitoring to identify and report suspicious activities.

Suspicious Activity Reporting

The guidance states financial institutions are not required to file suspicious activity reports (SARs) on customers solely because they are engaged in hemp activities in accordance with applicable law. For these customers, financial institutions should follow standard SAR procedures and file a SAR if there is suspicious activity. According to the guidance, such suspicious activity could include a customer who appears to be:

- Engaging in hemp activities in a state in which hemp production remains illegal;
- Using a state-licensed hemp business as a front for money laundering or illegal marijuana activities;
- Seeking to conceal or disguise involvement in a marijuana-related business activity; or
- Being unable or unwilling to provide sufficient information (e.g., a license) demonstrating the business is operating in compliance with the law.

Financial institutions should consider reviewing their BSA/anti-money laundering policies and procedures, along with their policies for filing SARs, to incorporate the points in FinCen’s guidance described above.

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COVID-19 Fair Credit Reporting Risks:
Financial Institutions Should Review Practices

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) amended the Fair Credit Reporting Act (FCRA) to add new reporting requirements that apply during the pandemic.

The Consumer Financial Protection Bureau (CFPB) released guidance on April 1 and June 16 addressing the CARES Act requirements and other important reporting obligations during the pandemic, emphasizing its focus on credit reporting accuracy and handling disputes, and noting it will not hesitate to take enforcement action against those who violate the law.

Importantly, the CFPB reported that credit reporting complaints tops the list of grievances it receives from consumers. There were 21,945 credit reporting complaints made to the CFPB in the month of May alone. Other regulatory agencies also receive large numbers of credit reporting complaints.

In addition, FCRA court actions filed in the past 12 months have increased. That number is expected to grow as consumers increasingly seek credit access to recover from the fallout of the pandemic. Many recent FCRA court actions against financial institutions claim that inaccurate information was furnished to credit reporting agencies (CRAs).

Because of the current risks, financial institutions should conduct a thorough review of their credit reporting practices and procedures to ensure compliance, particularly with respect to issues of significance during the pandemic. In this regard, the CFPB's Guidance on June 16 focused on the FCRA amendments under the CARES Act and other important provisions in the FCRA in light of the pandemic.

"Accommodations" Under the CARES Act

An "accommodation" is defined to include an agreement to defer one or more payments, make partial payments, forbear any delinquent amounts, modify a loan, or grant other relief.

If a financial institution makes such an accommodation to a consumer with respect to one or more payments on an account, and the consumer makes the payments as the accommodation requires (or if no payments are required), the financial institution should:

1. Report the account as current if it was current when the accommodation was made;
2. Maintain the account as delinquent if it was delinquent when the accommodation was made and not advance the delinquent status (e.g., if an account is 30 days past due at the time of the accommodation, a financial institution should not then report the account as 60 days past due during the accommodation);
3. If an account is brought current during the accommodation, including if the accommodation itself brings the account current (e.g., a loan modification eliminates a delinquency), report the account as current;
4. Avoid reporting an accommodation through a special comment code, as this does not satisfy the CARES Act requirement to report an account as current or to avoid advancing the delinquency as described above.

> **"The CFPB noted it will not hesitate to take enforcement action against those who violate the law.**

An accommodation includes relief that is granted voluntarily or pursuant to a legal requirement (e.g., under the CARES Act, consumers with a federally-backed mortgage loan may obtain a forbearance from their mortgage servicer).

The CARES Act reporting provisions addressing how a financial institution reports an account with an accommodation does not apply to accounts that have been charged-off.

Reasonable Investigation of Disputes

Financial institutions should conduct reasonable investigations of consumer disputes in a timely fashion.

Accuracy and Integrity of Information Financial Institutions provide to CRAs

Financial institutions should ensure all of the trade line information they furnish that reflects a consumer's status as current or delinquent is correct. Such information includes information on an account's payment status, scheduled monthly payment, and the amount past due. Furnishers are encouraged to confirm they understand the data fields used by CRAs for reporting purposes so as to facilitate accuracy.

Conclusion

As Benjamin Franklin famously said, "An ounce of prevention is worth a pound of cure." A financial institution should take time now to ensure its credit reporting practices are compliant with the law during the pandemic (and beyond). Preparation and compliance may help avoid future legal or regulatory issues that would be far more difficult and costly to address.

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FDIC Seeks Easier Partnerships for Banks and FinTechs

The FDIC announced a proposal that will allow banks to rely on certifications of financial technology companies (FinTechs) and their models. These certifications will be made by a standard-setting organization (SSO) collaborating with the FDIC. A primary goal of the proposal is to reduce the costs and burdens for community banks in assessing and validating FinTech models. According to the FDIC, these burdens have had a chilling effect on technology adoption at FDIC-supervised institutions.

The FDIC seeks comment from banks and others on the benefits and challenges of collaborating with an SSO for assessments and due diligence of: (i) FinTech models, such as credit underwriting models, by certifying such models; and (ii) FinTechs themselves by certifying certain aspects of their operations or condition.

The comment deadline is 60 days from the publication of the FDIC's proposal in the Federal Register. As of the date of the FDIC's announcement on July 21, 2020, this has not yet occurred.

This proposal represents a meaningful effort by the FDIC to help community banks partner with FinTechs to deliver innovative products and services. The pandemic has only hastened the migration of consumers and businesses to digital financial services. With this proposal, the FDIC seeks to lend a hand with the changing times.

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Virginia's New COVID-19 Workplace Safety Standards

The Virginia Safety and Health Codes Board formally adopted Temporary Safety Standards, effective immediately. They expire at the end of the year unless repealed earlier or extended.

The final version of the standards and downloadable resources can be found on the Department of Labor and Industry website.

These standards are designed to supplement and enhance Virginia Occupational Safety and Health (VOSH) guidance and regulations and do not override the Governor's orders. The regulations also indicate if an employer is complying with the CDC guidelines, the employer will be considered to be in compliance with these standards. Therefore, the question is whether your workplace is up to date with the CDC!

What is the risk to employers?

It is critical employers comply with these standards. Employers cannot discharge or discipline employees for raising a reasonable concern about COVID-19 in the workplace. This is why transparency and communication to employees about your efforts to keep employees safe in the workplace is critically important.

Do these standards apply to your workplace?

Whether these standards apply to you depends on whether certain job tasks your employees perform are considered **VERY HIGH**, **HIGH**, **MEDIUM**, or **LOW** risk for exposure purposes.

What matters is tasks—not positions, not products, services, or even the number of employees.

To make this determination, HR and management professionals will need to review all employee job functions and characterize them as **VERY HIGH**, **HIGH**, **MEDIUM**, or **LOW**. Factors that may be considered include:

- The presence of a person with known or suspected exposure;
- The number of employees in relation to the physical size of the working area;
- The working distance between employees;
- The duration and frequency of exposure through contact within six feet;
- Contact with airborne transmission, contaminated surfaces, workstations, break rooms, and other shared spaces;
- Flow through entrances and exits in and around the facility; and
- Use of shared work vehicles/transportation.

Many job tasks at the same place of employment can be designated as presenting either **VERY HIGH**, **HIGH**, **MEDIUM**, or **LOW** potential exposure risk. Employers cannot ignore potential hazards. The standards include a general "reasonableness" assumption, so if an employer could have known with reasonable diligence, then the employer may be deemed to have known.

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Immediate Actions! Within 24 hours of the discovery of a possible exposure at your worksite:

1. Notify employees (Keep the person's name confidential!)
2. Notify your landlord
3. Notify other employers whose employees are at your worksite
4. Notify Virginia Department of Health (VDH)
5. Notify Virginia Department of Labor and Industry (VDOLI) (only if three or more employees at the worksite test positive within a 14 day period)
6. Disinfect any areas where a person with a known exposure or suspected infection worked or used equipment
7. Where feasible, observe a 24-hour shutdown of those areas prior to disinfecting

Returning to work

If an employee tests positive, employers are required to use either a symptom-based, test-based, or time-based strategy for the employee to return to work. Remember to always consult with VDH first.

1. **Symptom-based strategy (for symptomatic employees):** Excludes an employee from returning to work until (i) at least three days (72 hours) have passed since recovery, defined as resolution of fever without the use of fever-reducing medications and improvement in respiratory symptoms (e.g., cough, shortness of breath) and (ii) at least 10 days have passed since symptoms first appeared.
2. **Test-based strategy (for asymptomatic or symptomatic employees):** Excludes an employee from returning to work until (i) resolution of fever without the use of fever-reducing medications, (ii) improvement in respiratory symptoms (e.g., cough, shortness of breath), and (iii) production of two negative test results from at least two specimens collected 24 hours or more apart.
3. **Time-based strategy**
   a. **For asymptomatic employees:** Excludes an employee from returning to work until at least 10 days have passed since the date of the employee's first positive COVID-19 diagnostic test, assuming the employee has not developed symptoms since the employee's positive test. If the employee develops symptoms, then the symptom-based or test-based strategy must be used.
   b. **For asymptomatic "close contact" employees:** Employees who come into close contact with, or who may live with, an individual with a confirmed diagnosis or symptoms may return to work after either 14 days have passed since the last close contact with the diagnosed/symptomatic individual. This includes the diagnosed/symptomatic individual receiving a negative COVID-19 test. (See the CDC's definition of "close contact.")

Requirements for ALL employers

1. Classify all job tasks according to the risk levels above. You may need a team to determine these risk classifications. We are available to provide professional counsel on classifying jobs and tasks accurately.
2. Do not use serological testing, also known as antibody testing, as a way to make return to work decisions or to classify employees.
3. Encourage employees to self-monitor for symptoms. Develop and implement policies and procedures for employees to report experiencing symptoms, having a potential exposure, or having tested positive.
4. Do not permit persons known or suspected to be infected to return to work or remain at the worksite.
5. Ensure sick leave policies are flexible and known to employees.
6. Work with subcontractors and other temporary employees or independent contractors to ensure proper protocols for preventing known exposures.
7. Create workplace protocols that include the following:
   - Post signs for physical distancing.
   - Decrease worksite density by limiting non-employee access.
   - Limit or close access to common areas like break rooms.
   - Require face coverings and other PPE if necessary.
   - Frequent sanitization and disinfection processes.
8. Disinfect all common spaces including bathrooms, frequently touched surfaces, and doors. These areas must be cleaned and disinfected at the end of each shift at a minimum. All shared tools, equipment, workspaces, and vehicles must be cleaned and disinfected prior to transfer from one employee to another.
9. Provide PPE.

Keep in mind this article is only a summary of a Virginia employer's requirements. As an employer, please take the time to familiarize yourself with these requirements and remember the Labor & Employment team is here to work with you in navigating your specific needs.

Labor & Employment Team

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GUEST COLUMN

M&A Corner: The COVID-19 Impact

The fallout from the COVID-19 pandemic is impacting the pace of U.S. bank merger and acquisition activity. Only 50 transactions were announced during the first six months of 2020 with a total deal value of approximately $6.5 billion. This compares to 119 deals announced during the first six months of 2019 with an aggregate deal value of over $40 billion.

The decline in transaction numbers by nearly 60% was accompanied by a decline in deal valuation. The median deal value to tangible common equity (TCE) value fell from 158% in the first half of 2019 to 140% for the comparable period of 2020.

This decline follows the pattern of declining bank stock valuations overall. One year ago, the ABA NASDAQ Community Bank Stock Index was trading at 326. The index peaked at 365 in late December of 2019. Since then, the index has been in a freefall to a current level of 239, a nearly 35% drop from the December peak.

It appears the COVID-19 epidemic will affect bank and thrift M&A activity for the balance of 2020. Many banks are building reserves in anticipation of looming asset quality problems. Stress tests assuming "V", "W" and "U" shaped economic recovery scenarios are being run to gauge possible losses and the impact on profits and capital levels.

Visibility on asset quality will remain clouded until there is a better understanding of the type of recovery the U.S. will experience and whether the federal stimulus and industry loan modifications are sufficient to help American businesses weather the pandemic storm.

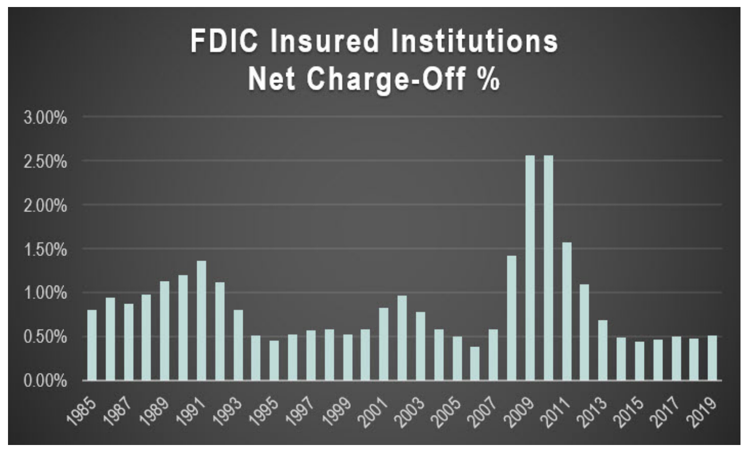
When the banking industry undergoes extreme economic uncertainty, it is difficult to predict the full measure of asset quality issues any given bank may experience, making it extremely challenging to value a target.

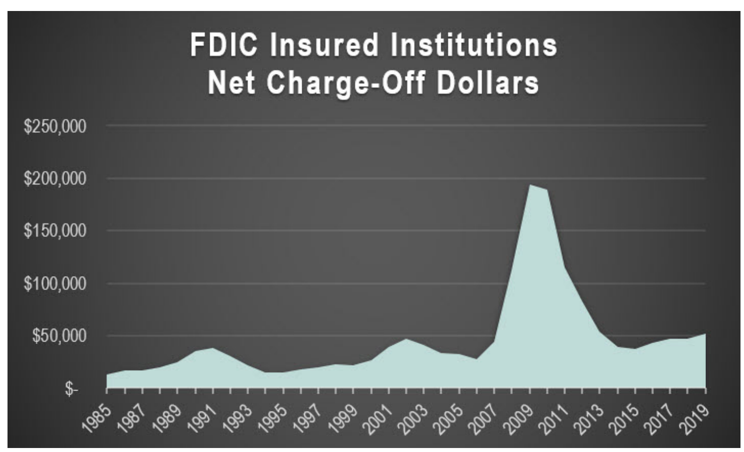
In recent years, annual net charge-off levels for the industry have been in a benign range of around 0.5%.

As the charts to the right reveal, much heavier charge-off experience tends to follow recessionary periods. Given current and expected levels of unemployment and GDP contraction, coupled with the continuing uncertainty of when the U.S. and the world can escape from the terrible effects of this pandemic, it would appear the industry could suffer materially higher loan losses over the coming quarters. If this occurs, U.S. bank M&A transactions will likely remain well below recent annual norms.

	2016	2017	2018	2019	2020 YTD*
# of Deals	182	255	254	259	50
Deal Value ($B)	$20.44	$26.45	$29.88	$55.11	$6.47
Assets Sold ($B)	$144.43	$155.72	$167.05	$410.59	$44.34
Deposits Sold ($B)	$114.97	$124.10	$133.88	$317.41	$35.53
AVG P/TCE (%)	136.1%	159.0%	170.1%	158.3%	140.3%

Source: S&P Global Market Intelligence
*YTD through June 30, 2020





Source: FDIC and Skyline Capital Strategies, LLC

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