COMMUNITY BANKING PROVISIONS IN THE CARES ACT

March 27, 2020

On Friday, March 27, 2020, the U.S. House of Representatives passed the largest stimulus package in U.S. history in response to the economic strain caused by the spread of the COVID-19 coronavirus, following similar action by the Senate on Wednesday. The President is expected to sign the bill into law right away. The Coronavirus Aid, Relief, and Economic Security Act - or the CARES Act - contains several provisions that are designed to aid community banks during these challenging times. This client alert summarizes and provides some analysis of the more important provisions of the Act.

Temporary Relief from Troubled Debt Restructurings

Section 4013 of the CARES Act allows financial institutions to temporarily suspend requirements for loan modifications related to the COVID-19 pandemic that would otherwise be classified as troubled debt restructurings ("TDRs"). In particular, any requirements under U.S. generally accepted accounting principles ("GAAP") and any determination of whether or not a modified loan qualifies as a TDR (including impairment for accounting purposes) are suspended. The provision requires the appropriate federal banking agency to defer to the determination of the financial institution regarding any suspension decision made under Section 4013. The applicable period for this provision begins on March 1, 2020 and ends on the earlier of December 31, 2020 or the date that is 60 days after the date on which the national emergency declaration made in connection with the COVID-19 coronavirus is terminated.

Importantly, any TDR-related suspension that is made must be related to the COVID-19 pandemic and, furthermore, cannot apply to a loan that was more than 30 days past due as of December 31, 2019. Section 4013 provides that financial institutions should continue to maintain records of the volume of loans involved and appropriate federal banking agencies may collect data about such loans for supervisory purposes.

This provision largely codifies the regulators' Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus released on March 22, 2020. However, this provision goes further in allowing institutions to opt out of the GAAP requirements related to TDRs for a period of time. The provision applies for the duration of the modification, so long as the modification was made in reaction to COVID-19 related circumstances. This provision should give banks further comfort in modifying loans in response to the current health crisis.

Optional Temporary Relief from Current Expected Credit Losses

Section 4014 of the CARES Act allows insured depository institutions and bank holding companies and their affiliates to temporarily delay measuring credit losses on financial instruments under the new Current Expected Credit Losses methodology, or CECL. This temporary measure expires at the earlier of December 31, 2020 or the date on which the national emergency declaration made in connection with the COVID-19 coronavirus is terminated.

While most community banks are not subject to CECL requirements for 2020 in any event, this relief is important in keeping credit flowing from larger banks. Our understanding is that the CECL model is particularly punitive when making loans during times of economic distress, and this change will ease that burden for public bank holding companies. It is our hope that the Financial Accounting Standards Board will use this pause to reconsider CECL given that the model appears to be deeply flawed.

In furtherance of the relief provided through Section 4014 of the CARES Act, the FDIC, Federal Reserve and OCC also today adopted an interim final rule, dated March 27, 2020, providing banking organizations with an option to further delay the effects of CECL's requirements. Under prior rule-making, the agencies had included a transition option to allow banking organizations to phase in over a three-year period the day-one adverse effects of CECL on their regulatory capital ratios. The interim final rule enables banking organizations that adopt CECL during the 2020 calendar year to elect to delay for two years the commencement of that three-year transition period, effectively resulting in a five-year transition period. Banking organizations that have already adopted CECL will have the option to elect the three-year transition option provided under prior rule-making or the five-year transition contained in the interim rule.

The interim final rule is intended to mitigate some of the uncertainty resulting from the increase in credit loss allowances under CECL during a challenging economic environment by temporarily limiting the effects of CECL on regulatory capital and to enable banking organizations to better focus on supporting lending to creditworthy households and businesses. The interim final rule is effective immediately, although the agencies are seeking comment on certain implications of the interim final rule.

FDIC Debt Guarantee Authority

Section 4008 of the CARES Act authorizes the FDIC to temporarily establish a debt guarantee program to guarantee the debt of solvent insured depositories and depository institution holding companies. Noninterest-bearing transaction accounts are expected to be covered under the debt guarantee program, and the FDIC will also be empowered to guarantee other debt issued by banks and their holding companies. Essentially, this provision authorizes the resurrection of the FDIC's Temporary Liquidity Guarantee Program used during the financial crisis.

While the program will be subject to a to-be-announced cap, we look forward to the FDIC's implementation of the program. We believe a sizable increase in insurance for transaction accounts should help provide comfort to large depositors of community banks.

Temporary Reduction of Community Bank Leverage Ratio

Section 4012 of the CARES Act requires the federal banking agencies to temporarily reduce the Community Bank Leverage Ratio, or CBLR, for qualifying community banks (those having assets under $10 billion) from 9 percent to 8 percent, and also provides for a reasonable grace period if a qualifying community bank's CBLR falls below this prescribed level. The temporary measure in Section 4012 expires at the earlier of December 31, 2020 or the date on which the national emergency declaration made in connection with the COVID-19 coronavirus is terminated.

Given the implications of prompt corrective action if the requirement is breached, we do not view opting into the CBLR as a sound choice for most community banks, even at the lower requirement.

SBA Paycheck Protection Program

Perhaps the most interesting provision of the CARES Act is the ability for banks to lend, and for their customers to borrow, pursuant to the Paycheck Protection Program to be administered through the Small Business Administration, or SBA.

Section 1102 of the CARES Act extends eligibility to any business concern, nonprofit organization, veterans organization, or tribal business concern if the entity employs no more than (i) 500 employees or (ii) the standard number of employees established by the SBA for the industry in which the entity operates. Sole proprietors, independent contractors and eligible self-employed individuals may also be eligible. Finally, business concerns with more than one physical location may be eligible, provided there are no more than 500 employees per physical location that is assigned a North American Industry Classification System code beginning with 72 at the time of disbursal. Eligible recipients applying for a covered loan must certify that: (i) the loan is necessary to support ongoing operations due to the current uncertain economic conditions; (ii) funds will be used to retain workers and maintain payroll or make mortgage payments, lease payments, and utility payments; (iii) the applicant does not have an application pending for a loan under the Small Business Act for the same purpose and same amounts; and (iv) between February 15, 2020 and December 31, 2020, the applicant has not received a loan under the Small Business Act for the same purpose and in the same amounts applied for or received under a covered loan.

Maximum Loan Amount

Section 1102 of the CARES Act limits the maximum principal amount of eligible loans to the lesser of:

- $10 million; or
- (i) The average total monthly payments by applicant for payroll costs incurred during 12-months before the loan date (if the applicant is a seasonal employer, the average total monthly payments for payroll during a 12-week period beginning February 15, 2019, or at election of the applicant, March 1, 2019, and ending June 30, 2019) multiplied by 2.5, plus (ii) the outstanding amount of a loan made during period beginning on January 31, 2020 and ending on the date on which covered loans are made available to be refinanced under the covered loan; or
- For an eligible recipient that was not in business between February 15, 2019 and June 30, 2019, (i) the average total monthly payments by the applicant for payroll costs incurred between January 1, 2020 and February 29, 2020 multiplied by 2.5, plus (ii) the outstanding amount of a loan made during the period beginning January 31, 2020 and ending on the date on which covered loans are made available to be refinanced under the covered loan.

Allowable Uses of Covered Loans

Section 1102 of the CARES Act permits loan funds to be used for the following purposes: (i) payroll costs; (ii) costs related to continuation of health care benefits during periods of paid sick, medical, or family leave, and insurance premiums; (iii) employee salaries, commissions, or similar compensation; (iv) payments of interest on any mortgage obligation (not including any prepayment or principal payments); (v) rent (including rent under a lease agreement); (vi) utilities; and (vii) interest on any other debt incurred before February 15, 2020.

Fee Waiver, Maturity, and Interest

For the period beginning February 15, 2020 through June 30, 2020, Section 1102 of the CARES Act waives the annual 0.55% fee and the guarantee fee due to the SBA. Covered loans may have a maximum maturity of 10 years from the date the borrower applies for loan forgiveness. Note that any principal balance remaining after reduction due to forgiveness will continue to be guaranteed by the SBA. The maximum rate of interest charged may not exceed 4%.

Lender Fee

Under Section 1102 of the CARES Act, lenders will be reimbursed at the following rates: (i) 5% for loans of not more than $350,000.00; (ii) 3% for loans of more than $350,000.00 and less than $2,000,000.00; and (iii) 1% for loans of not less than $2,000,000.00. It is important to note that Section 1102 requires the SBA to issue reimbursements within 5 days after disbursement of a covered loan.

Loan Forgiveness for Certain Costs

Section 1106 of the CARES Act permits forgiveness of loans in an amount equal to costs incurred during the "covered period" for: (i) payroll costs; (ii) payments of interest on any mortgage incurred prior to February 15, 2020 (not including prepayments or principal payments); (iii) any payment on rent obligated under a leasing agreement in force before February 15, 2020; and (iv) utility payments on electricity, gas, water, transportation, telephone or internet access for which service began before February 15, 2020. The "covered period" is the eight-week period after the loan is made.

Limitations on the Amount of Forgiveness

Section 1106 of the CARES Act states that the amount of any loan forgiveness cannot exceed the principal amount of such loan. The amount of any loan forgiveness will also be reduced by multiplying the forgiveness amount by the quotient of the average number of full-time equivalent employees per month employed during the 8-week period following the origination date of the loan, divided by:

- the average number of full-time equivalent employees per month employed from February 15, 2019 through June 30, 2019; or
- the average number of full-time equivalent employees per month employed from January 1, 2020 through February 29, 2020; or
- for a seasonal employer, the average number of full-time equivalent employees per month employed from February 15, 2019 through June 30, 2019.

The amount of the loan forgiveness will also be reduced by the amount of any reduction in total salary or wages of any employee (who in 2019 did not receive annualized pay in excess of $100,000.00) that is in excess of 25% of the salary or wages of the employee during the most recent full quarter before the 8-week period following the origination date of the loan. Eligible recipients may receive loan forgiveness for additional wages paid to tipped employees.

Exemption for Re-Hires: Halting the Reduction of Forgiveness

In order to encourage employers to reduce unemployment, the amount of forgiveness will not be reduced if employees are re-hired or salaries are raised to pre-emergency levels. Specifically, Section 1106 of the CARES Act states the amount of any loan forgiveness will not be reduced due to (i) a reduction in the number of full-time equivalent employees, or (ii) a reduction in the salary of 1 or more employees during the period beginning February 15, 2020 and ending 30 days after the enactment of the CARES Act if, not later than June 30, 2020, the eligible employer has eliminated such reduction in full-time equivalent employees or such reduction in salary.

Conclusion

While there are many details to be addressed in the language of the CARES Act and further clarifications to be made as the above-described programs are implemented, the Act provides important opportunities and protections for community banks. Our hope is that these measures accelerate the recovery of the economy and enhance the health of community banks.

PROFESSIONALS

CHET A. FENIMORE
Managing Partner, Austin
CFenimore@fkhpartners.com
Direct: (512) 583-5901

GEOFFREY S. KAY
Partner, Austin
GKay@fkhpartners.com
Direct: (512) 583-5909

LOWELL W. HARRISON
Partner, Austin
LHarrison@fkhpartners.com
Direct: (512) 583-5905

ZONNIE BRECKINRIDGE
Of Counsel, Austin
ZBreckinridge@fkhpartners.com
Direct: (512) 583-5911

STEPHANIE E. KALAHURKA
Partner, Kansas City
SKalahurka@fkhpartners.com
Direct: (816) 292-8141

DEREK W. MCGEE
Partner, Austin
DMcGee@fkhpartners.com
Direct: (512) 583-5902

JONATHAN HIGHTOWER
Partner, Georgia
JHightower@fkhpartners.com
Direct: (770) 282-5112

JEREMY S. LEMMON
Partner, Austin
JLemmon@fkhpartners.com
Direct: (512) 583-5903

PAM G. O'QUINN
Partner, Dallas
POQuinn@fkhpartners.com
Direct: (214) 273-6244

BRENT STANDEFER, JR.
Partner, Austin
BStandefer@fkhpartners.com
Direct: (512) 583-5906

KEVIN STRACHAN
Partner, Georgia
KStrachan@fkhpartners.com
Direct: (770) 282-5117

JOHN T. WILSON
Attorney, Austin
JWilson@fkhpartners.com
Direct: (512) 583-5923

CRYSTAL HUFFMAN
Attorney, Georgia
CHuffman@fkhpartners.com
Direct: (770) 282-5114

NICHOLAS J. GALLION
Attorney, Austin
NGallion@fkhpartners.com
Direct: (512) 583-5915

WILLIAM C. WILSON, JR.
Attorney, Austin
WWilson@fkhpartners.com
Direct: (512) 583-5904