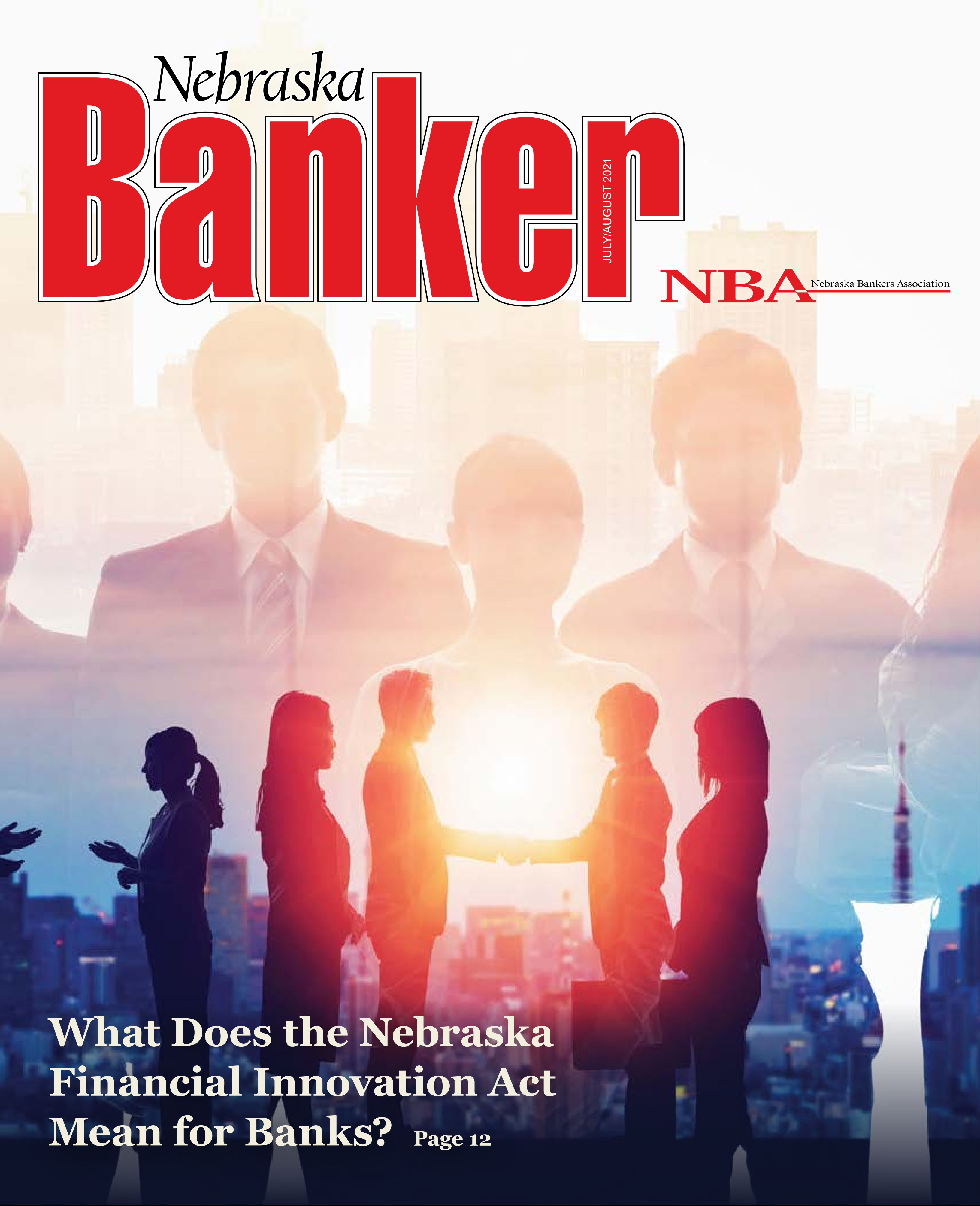
Nebraska

Banker

JULY/AUGUST 2021

NBA Nebraska Bankers Association



What Does the Nebraska Financial Innovation Act Mean for Banks?

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Nebraska Banker
JULY/AUGUST 2021

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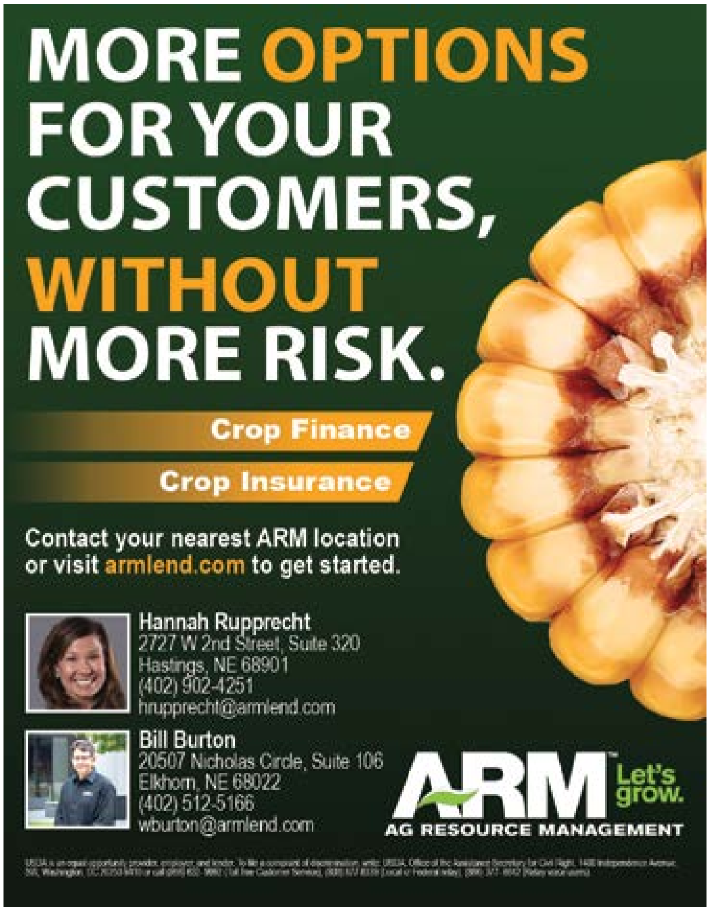
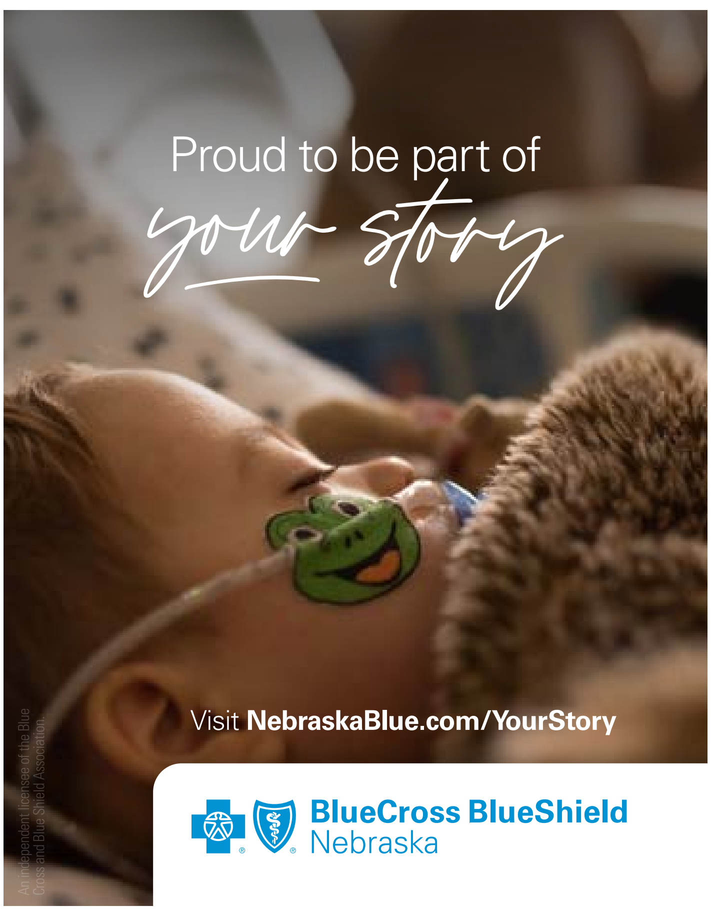




NBA BOARD OF DIRECTORS

NBA EDITORIAL STAFF

RICHARD BAIER
NBA President and CEO
richard.baier@nebankers.org

KARA HEIDEMAN
Director of Communications
and Marketing
kara.heideman@nebankers.org

NBA Nebraska Bankers Association
233 South 13th Street, Suite 700
Lincoln, NE 68508
Phone: (402) 474-1555 • Fax: (402) 474-2946
nebankers.org

Richard Baier, President and CEO, Nebraska Bankers Association

ONE OF THE CHALLENGES FOR HE NBA TEAM IS synthesizing the input we receive from our members with relevant statistical analysis. Attracting and retaining the next generation of bankers is one of those unique issues where member input and the data converge perfectly. Every member visit over the past year has included a conversation about the difficulty in hiring new banking professionals. We also recognize that Nebraska has one of the lowest unemployment rates in the country. However, did you know that the NBA online job board received more than 15,000 visitors last year? To enhance the banking industry's ability to attract new and diverse talent, the NBA is pleased to roll out the new Job Board with upgraded features.

NBA members can view and access the new board at nebankers.mcjobboard.net/jobs or find it on our main website (nebankers.org) by clicking on Workforce.

For more than 15 years, the NBA has provided a free job board to members to promote career opportunities. The new NBA Job Board provides a much-improved user interface for both employers and job seekers. NBA members can now easily post jobs directly to the Job Board; likewise, banks can add promotional logos.

If banks have their own online application process, applicants will be directed to the bank's site. For those members without an application portal, applicants can easily use the system available on the NBA Job Board. The system also allows banks to track and communicate directly with applicants, similar to national recruitment sites. Banks will also be able to post full-time, part-time, temporary/contract and internship positions.

For job seekers, the new Job Board allows interested parties to search for career opportunities by keyword or location. In addition, the system will enable applicants to upload their resumes for review by potential employers. Finally, job seekers can sign up for email alerts when new positions that meet their interests are posted. Your NBA leadership will utilize the new Job Board as a tool to increase high school and college student interest in banking careers, which will prove especially valuable at job fairs and when making classroom presentations.

As we evaluate additional strategies to attract increased student interest in banking and finance, the NBA Foundation Board is planning additional changes to several existing programs. For example, starting next year, the NBA will begin offering select banking/business scholarships at the community college level. Similarly, we are working closely with our higher education institutions to modernize the NBA's scholarship and philanthropic investment strategies.

We look forward to working closely with our members to boost the number of individuals interested in banking as a career choice.

Before I close, I wanted to draw your attention to two upcoming programs of interest. First, on October 6-7, the NBA will host a pandemic-modified 2021 NBA Convention Lite at the Cornhusker Marriott in Lincoln. Also based on continued questions and dialogue with numerous NBA members about cryptocurrency, digital assets and blockchain technology, the NBA will be hosting a Cryptocurrency/Digital Asset 101 training event on November 3 at the Cornhusker Marriott in Lincoln. This will be an excellent opportunity to learn more about digital assets and how they will impact the future of banking and finance in the country. Following the workshop, banker registrants for this event will be given free access to two webinars focused on "Profit Opportunities for Banks in Digital Assets" and "How Do Bank Regulators View Digital Assets."

As always, thank you for what you are doing to support your customers and our Nebraska communities!

Contact Richard Baier at (402) 474-1555 or richard.baier@nebankers.org.

Time's Up: Congress Must Stop Credit Union Purchases of Taxpaying Banks

Rob Nichols, President and CEO, American Bankers Association

AFTER TAPERING OFF DURING THE pandemic, the trend of credit unions buying taxpaying community banks is back – and credit unions are becoming more aggressive than ever in their pursuit of acquisition targets. The first half of 2021 has already seen two precedent-shattering deals: Jacksonville, Florida-based VyStar Credit Union's acquisition of a $1.6 billion Georgia bank is by far the largest purchase of a bank purchase by a credit union to date. And more recently, the announcement by Iowa-based Green State Credit Union that it would simultaneously acquire not one but two community banks in the Midwest.

Acquisitions like these are a bad deal for taxpayers, a bad deal for communities, and a bad deal for consumers. They erode state and federal tax bases at a fundamental level, diverting funds away from essential infrastructure projects and other government initiatives. Perhaps even more egregiously, in the case of VyStar – which paid an 80% premium on its acquisition transaction – is the fact that the firm's tax-exempt status means American taxpayers effectively subsidized the purchase.

Analysis by the Government Accountability Office shows that credit unions are now serving more middle- and upper-income customers rather than customers of "small means" – the congressional mandate behind the credit union tax exemption. Rather than focusing on low-to-moderate-income communities sharing a common bond, credit unions increasingly target a wealthier client base, market wealth management services, luxury goods financing and commercial banking services. This is not what credit unions were created to do.

Consumers also lose out when credit unions gobble up community banks, given that credit unions are not held to the same rigorous regulatory standards as banks when it comes to consumer protection or community reinvestment.

These deals are also bad for the credit union industry itself, as small credit unions are increasingly forced to compete with an expanding cadre of large, growth-oriented firms. Yet despite all this, credit unions continue to persist in their pursuit of community bank acquisitions, aided and abetted by the National Credit Union Administration, which went so far as to attempt to formally codify this process with a proposed rulemaking last year – a step ABA vigorously opposed.

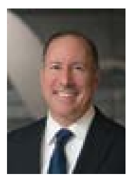
These efforts represent yet another assault on the statutory definition of "credit unions" enshrined in the Federal Credit Union Act that has been going on for years. It's even been acknowledged at the highest levels of the leadership of the NCUA's. One need look no further than former NCUA Chairman Mark McWatters' warning that the agency he once led has become "inappropriately emboldened" and has allowed the institutions it is charged with supervising to creep far beyond their statutory boundaries.

It's time for Congress to step in.

Lawmakers must determine whether these types of acquisitions – and the negative consequences that follow – align with the public policy goals Congress intended when it created the credit union tax exemption in the first place.

Until they do, the banking industry must continue to push back – as it has in states like Iowa and Colorado, where state regulators have determined that local statutes do not allow credit unions to acquire state-chartered banks. ABA will continue its advocacy against these types of mergers – as we did in a recent letter to the OCC, highlighting the particular threat they pose to the mutual bank business model.

We will continue to make these arguments loudly and often because we know that when tax-exempt credit unions overtake taxpaying banks, everyone loses.



Email Rob Nichols at rnichols@aba.com.

What Does the Nebraska Financial Innovation Act Mean for Banks?

Gray Derrick and **J. Scott Searl**, Baird Holm, LLP

ON MAY 25, 2021, GOVERNOR RICKETTS SIGNED THE Nebraska Financial Innovation Act ("NFIA" or the "Act") into law, making Nebraska the second state, following Wyoming, to establish digital asset depositories.[1] NFIA authorizes the formation of digital asset depositories, either as a separate department of an existing financial institution or as a newly chartered digital asset bank, upon approval from the Nebraska Department of Banking and Finance (the "Department").[2] Once approved, a digital asset depository can engage in certain services relating to digital assets (e.g., cryptocurrency).

What Services Can a Digital Asset Depository Provide?

Under NFIA, a digital asset depository can provide custody services for cryptocurrency (such as Bitcoin). Although not specifically addressed in NFIA, cryptocurrency custody services presumably mean a depository may hold the unique cryptographic keys associated with a customer's virtual currency. Cryptographic keys are strings of data that lock or unlock encrypted digital asset data. Cryptocurrency owners have a public key that allows them to accept payments from other cryptocurrency users and a private key to prove ownership of the specific digital currency.

Apart from providing custodial services, digital asset depositories may also:

- Provide payment services upon a customer's request;
- Conduct non-lending digital asset banking business for customers, including facilitating the provision of borrowing or lending in which digital assets are borrowed, paid, or pledged to a lender in exchange for digital assets;
- Issue stablecoin (cryptocurrency backed by a reserve asset such as being tied to the U.S. dollar) and hold stablecoin deposits at an FDIC-insured financial institution which has a main chartered office or branch in Nebraska; and
- Use stablecoin and independent node verification networks for payment activities.

NFIA also authorizes a financial institution to serve as a qualified custodian for a registered investment adviser subject to applicable SEC rules and additional rules and regulations adopted by the Department.

How is a Digital Asset Depository created?

NFIA establishes two ways to create a digital asset depository. Financial institutions[3] may apply for authority to operate a depository as a separate department within the financial institution. Although NFIA does not define what is required to maintain a "separate department," it requires an amendment to an institution's articles of incorporation to authorize the conduct of a digital asset depository business. Alternatively, five or more adult persons (including at least one Nebraska resident) may form a digital asset depository by applying to the Department to obtain a new charter.

NFIA provides that a financial institution may invest up to 10% of its capital and surplus in a digital asset depository institution unless written approval to invest a higher percentage is obtained from the Department. The Act further provides that bank holding companies may apply to maintain a digital asset depository, subject to federal and state law.

An application by a financial institution to form a department as a digital asset depository business or an application by individuals to create a newly chartered digital asset depository institution requires, in each case, the following:

- A detailed business plan;
- Estimated operating expenses for the first three years (with applicants seeking a new charter required to pay a surplus fund in such amount or other amount established by the Department);
- A proposal for compliance with NFIA requirements; and
- Payment of a $50,000 application fee.

Applicants seeking a new charter must submit articles of incorporation, evidence of a minimum of $10 million capital stock (which must be solicited before the filing of an application and returned without loss if an application is denied), and identification of any investors holding 10% or more of the proposed institution's equity.

Cryptographic keys are strings of data that lock or unlock encrypted digital asset data.

After a complete application has been filed, the Department will investigate the background of officers, directors and shareholders owning 10% or more of the applicant's equity. A public hearing on the application will be held within 60 to 120 days after notice from the Department that the application is in order.[4] Within 90 days after receiving a public hearing transcript, the Department will decide on the application based on criteria outlined in NFIA.

What Compliance Requirements Must Digital Asset Depositories Satisfy?

NFIA includes several compliance requirements for digital asset depositories. Among other things, a digital asset depository must:

- Maintain its main office and the primary office of its CEO in Nebraska;
- Help meet the digital financing needs of communities in which it operates, and maintain and update a public file and its website(s) with information about its efforts to meet community needs;
- Maintain unencumbered liquid assets of at least 100% of the digital assets in custody at all times;
- Submit reports regarding the depository's condition (such reports shall be made publicly available, with the Department having the ability to impose a fee of $5,000 for each day a report is overdue);
- Be subject to examination to determine the depository's condition and resources, mode of managing the depository's affairs, actions of its officers and directors in the investment and disposition of funds, the safety and prudence of digital asset depository management, compliance with NFIA and other matters as the Department may require;
- Furnish a surety bond or pledge assets in an amount determined by the Department to be sufficient to cover the costs of liquidation or conservatorship;
- Maintain appropriate insurance or a bond covering operational risks of the digital asset depository, which must include coverage for directors' and officers' liability, errors and omissions liability, and information technology infrastructure and activities liability; and
- Pay an assessment (as determined by the Department and approved by the Governor) which shall offset costs of supervision and administration of the Act.

In addition, digital asset depositories must adhere to several customer-facing requirements, including:

- The customer must provide sufficient evidence to the depository that it will comply with the anti-money laundering,

COUNSELOR'S CORNER — continued on page 14

customer identification and beneficial ownership requirements under the Bank Secrecy Act and policies and procedures of the depository;

- If the customer is a legal entity, then it must provide reasonable evidence that it conducts a lawful, bona fide business;
- The terms and conditions of a customer's digital asset depository account must include a list of mandated disclosures, such as a schedule of fees and the manner and timing of their calculation, statements that digital asset depository accounts are not FDIC insured and that an investment in digital assets is volatile and may result in total loss of value and other statements outlined in NFIA relating to risks associated with digital assets; and
- All advertising, marketing materials and websites must also include conspicuous notices that digital asset deposits and accounts are not FDIC-insured, as well as the text of a statutory notice outlined in NFIA regarding the substantial risk and speculative nature of holding digital assets.

NFIA also includes additional restrictions that apply uniquely to newly chartered digital asset depository institutions (as opposed to departments established within existing financial institutions), including:

- Requiring "digital asset bank" to be used in the institution's name so that it does not resemble the name of any other financial institution transacting business in Nebraska;
- Prohibiting acceptance of U.S. currency demand deposits or U.S. currency that may be withdrawn by check or similar means; and
- Prohibiting consumer, commercial, or mortgage loans of any fiat currency, including temporary credit relating to overdrafts.

If a financial institution serves as a qualified custodian for a registered investment adviser, NFIA sets forth additional restrictions to those services.

What's Next?

NFIA authorizes the Department to adopt rules and regulations necessary to implement the Act, providing further guidance regarding the Act's provisions. Federal bank regulators are also expected to issue guidance concerning digital assets. The law will continue to evolve in this area.

Banks, bank executives and bank owners interested in the potential expansion of banking services to digital assets services or the entrance into such area by non-bank owners should continue to monitor these legal developments and best practices that may apply to digital asset services covered by NFIA.

[1]On June 10, 2021 the Texas Department of Banking issued a notice affirming that Texas state-chartered banks may provide customers with virtual currency custody services, provided the bank has adequate protocols in place to effectively manage the risks and comply with applicable law.

[2]NFIA also adds a new section to the Nebraska Uniform Commercial Code relating to controllable electronic records, including security interests in digital assets. NFIA's provisions relating to the creation and operation of digital asset depositories become effective October 1, 2021. The remainder of the Act (including the UCC provisions which are not discussed in this articles) is effective July 1, 2022.

[3]"Financial institutions" under NFIA include national or state chartered banks, S&Ls, savings banks, building and loan associations and trust companies; credit unions are not included.

[4]The Department shall electronically send notice of the hearing to financial institutions in Nebraska, federal agencies and financial industry trade groups.

Gray Derrick is a partner at Baird Holm LLP and chair of the Firm's Technology and Intellectual Property Section. He focuses his practice on developing, acquiring, and using technology and other forms of intellectual property.

J. Scott Searl is a partner at Baird Holm LLP and the Firm's Financial Services Industry Team leader. Scott represents banks, bank holding companies and their owners on mergers and acquisitions, corporate governance and regulatory matters.

Carrie Schwab and Greg Dittman, summer associates of the Firm, contributed to this article.

The Risk Value of Egress Filtering

Kelley Hesse, Information Security Consultant, DFIR Analyst, SBS Cybersecurity, LLC

MONITORING FIREWALL TRAFFIC IS A FUNDAMENTAL PART of cybersecurity. It is well known that ingress filtering is crucial to business operations, but what about egress filtering? Neglecting egress filtering can be compared to neglecting your company's yearly budget. Just for a moment, imagine giving all your employees blank checks and hoping they do not bankrupt you. If your first thought when reading that sentence is "we would never do that," then you are part of the majority. There are many things to consider when implementing a company's budget: Who has the authority to spend? On what are employees authorized to spend money? Which employees have bigger budgets than others? How much can the company afford to spend? To avoid financial hardships, your company tracks all outgoing purchases. In this example, the blank checks are traffic leaving your firewall, and the employee's purchases are connections to anything on the internet. Controlling the egress flow of information is just as important as managing the outflow of cash to your organization. Implementing host-based egress filtering, especially whitelisting with DNS verification, decreases risk across your entire enterprise.

What is Egress Filtering?

Egress filtering controls the outflow of traffic from the network. Meaning, if an administrator does not configure the network's firewall correctly, outgoing traffic can connect to unknown and sometimes unwanted/malicious hosts. This could be harmful to your network because those connections could be a part of a cyberattack.

The Risk Value

Let's walk through a scenario that is all too familiar for too many companies. An employee at a company receives a phishing email that is claiming to come from Microsoft. The email states

> Implementing egress filtering has two policy options: default allow policy and default deny policy. Default allow policy is thought to be the most straightforward filter to apply and is commonly used in medium to smaller organizations.

an urgent security update that must be applied to the employee's computer immediately, or else their computer will be vulnerable to malicious exploits. The email goes on to provide instructions for the employee to follow. The employee follows the instructions and ventures to the website the email provided and downloads the "update" to their computer. Little does the employee know that when the "update" was installed, it was really a payload that connects to a server and installs malicious applications. Those applications give the attacker control of the employee's system and allow the attacker to perform post-exploitation processes, gaining a foothold in your network and possibly exposing the user's email content to the attacker.

Apart from security awareness training and teaching the employee how to spy a phishing email, this is a crucial instance where egress filtering would have prevented the attack from being. When the employee navigated to the foreign website to download the security "update," egress filtering combined with website reputation or DNS resolution would have seen the site had a bad reputation and blocked the employee from accessing the website. If this had been done, the employee would have been prevented from downloading the "update" to their computer. This example is an excellent reminder that layered security is always beneficial to include in a network. Layered security is where an organization uses multiple segments to protect the organization on more than one level. Data resides in all different levels of an organization, including across multiple applications. Implementing layered security will ensure that data stays protected.

Later in the scenario, we read that the "update" installed continued to connect to a server and install malicious applications. Having egress filtering configured properly on the organization's firewall would have prevented the malware from connecting to the command server on the internet. Preventing that outgoing connection would have then stopped the attacker's ability to download the applications and would cease the attacker from gaining access to the employee's computer.

Lastly, if the organization would have had egress filtering in place, they would have been aware of the network traffic leaving their environment. Any activity categorized as unauthorized would have been logged and alerted. The company would have been notified to review the logs, then advised to follow up and find the source of the unauthorized traffic activity.

Implementation

Implementing egress filtering has two policy options: default allow policy and default deny policy. Default allow policy is thought to be the most straightforward filter to apply and is commonly used in medium to smaller organizations. This filter allows all outbound traffic in the simplest of terms unless it is expressly not permitted to leave the network – this is called blacklisting. Usually, policies would be created to block traffic that uses unneeded protocols or exploited destination ports. Default deny policy can be thought of as the direct opposite. This means that all outbound traffic is prohibited unless it is specifically allowed – this is called whitelisting.

Another way to implement egress filtering is directly on each host. Implementing a DNS verification system provides a secure web gateway to help protect an organization's network at the DNS layer. This can be especially useful for remote users because a cloud-based enterprise can be implemented. This can be further enhanced when used in conjunction with the host's firewall to perform egress filtering. The network perimeter is disappearing in the modern computer world. Technology companies like your organization need to be prepared with the same data protection level for your internal network.

Egress filtering is often an overlooked cybersecurity control, and because most of the time it is not configured, many organizations never get to take advantage of its risk mitigation. However, seeing the benefits of stopping a malware attack paired with gaining a greater understanding of traffic leaving your network or hosts, the risk mitigation that egress filtering can provide is invaluable. Implementing host-based egress filtering, especially whitelisting with DNS verification, decreases risk across your entire enterprise.

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Mortgage Borrowers Amid the COVID-19 Pandemic 2021 and Onward

Tim Dominguez, Associate General Counsel, Compliance Alliance

AT THE BEGINNING OF THE YEAR, ACTING DIRECTOR DAVE Ujieo of the Consumer Financial Protection Bureau (CFPB) stated the agency would shift its focus to a more assertive role regarding enforcing regulations protecting consumers. Because of this shift, one of the chief enforcement priorities would be to emphasize protection and compliance with regulations for borrowers impacted by the COVID-19 pandemic. In addition, now that we are in the middle of 2021, the CFPB has published a report analyzing data on mortgage borrowers most affected by the pandemic and proposed a collection of rules extending protections at least until the middle of next year. Because of these publications, banks should prepare for a more significant regulatory emphasis on COVID-19 protections and fair lending practices.

According to the CFPB's Special Issue brief titled Characteristics of Mortgage Borrowers, released May of this year, the COVID-19 pandemic's financial impact on banks and mortgage customers has not been this vast and deep since the Great Recession of 2010.

Because of the pandemic's economic reach, we have seen an increase in the availability of forbearance programs that temporarily allow borrowers to stop making payments even when delinquent. The CFPB analyzed the data and discovered that Black and Hispanic borrowers make up a significant percentage of all mortgage borrowers at 18%. However, this same group of borrowers makes up an even more substantial percentage of forbearance at 33% or delinquent at 27%. The CFPB also found that loans with a loan-to-value (LTV) ratio above 60% were more common for borrowers in forbearance or delinquent than those current with their mortgages. Additionally, the CFPB established those with an LTV ratio above 95% were most susceptible to defaulting on their mortgage.

The data shows that loans in forbearance or delinquent were more likely to be single-borrower loans with a sizable amount being delinquent for at least 30 to 60 days. In crystallizing these findings, forbearance and delinquency are more common for Black or Hispanic borrowers, have a higher LTV, or have difficulty paying other obligations. Acting Director Uejio stated, "Communities of color have been hit hard by the pandemic, and the latest data show that many borrowers are still hurting. The CFPB will continue to seek and actively respond to developments in the market, doing everything in our power to help families stay in their homes."

This runs true with the CFPB's priorities earlier this year in taking a more assertive role in enforcing consumer protections due to COVID-19 and taking steps to ensure racial equality in financial services.

In response to the hardships mortgage borrowers are experiencing due to the financial implications of this pandemic, the CFPB has issued several proposed amendments to the Mortgage Servicing Rules and provided a tentative effective date of Aug. 31, 2021. The notice of proposed rulemaking (NPRM) adds a general definition for "COVID-19-related hardship" that matches the CARES Act.

The proposition in the context of early intervention requires servicers to ask whether a borrower not in forbearance at the time of live contact is experiencing a COVID-19 related hardship. If the borrower indicates in the affirmative, the servicer would be required to list and describe available forbearance programs and explain how the borrower can apply for them.

Loss Mitigation

The NPRM also contains amendments to the loss mitigation procedures. Current rules require servicers to take reasonable due diligence in obtaining a complete application for loss mitigation. This rule specifically focuses on what would constitute due diligence for borrowers in short-term forbearance due to a COVID-19-related hardship. For example, suppose the program was offered in an applicable circumstance and was based on an incomplete application. In that case, the servicer must contact and determine if the borrower wants to complete their application and proceed with a total loss mitigation evaluation at least 30 days before the short-term program ends. When evaluating an application, the proposed rule would now allow servicers to offer certain modifications based on an incomplete application if specific criteria are met. This criterion includes the loan modification extending the loan length by no more than 40 years, and the borrower's preexisting delinquency would be resolved by accepting the loan modification.

> The NPRM adds a temporary COVID-19 pre-foreclosure review period in which a servicer cannot make the first notice or filing for foreclosure.

Foreclosure Implications

Another facet of the loss mitigation procedures impacted by the CFPB's NPRM is foreclosures. While certain agencies and Government-Sponsored Enterprises (GSEs) have all placed their moratoria on foreclosure, the NPRM's effect on foreclosures is not limited only to the secondary market or federally backed loans. The NPRM adds a temporary COVID-19 pre-foreclosure review period in which a servicer cannot make the first notice or filing for foreclosure. The current rule states a servicer is prohibited from making this notice or filing unless the borrower is more than 120 days delinquent. This new rule proposes to add an overarching prohibition against making the notice or filing for foreclosure because of any delinquency until after Dec. 31, 2021. Meaning, if this rule becomes final, foreclosures may not occur until after the year is over, providing extra protection for borrowers impacted by the pandemic.

If they have not already done so, banks should now take steps in preparing to provide customers impacted by COVID-19 more protections as well as comply with any regulations requiring them to do so. Further, true to the CFPB's direction, banks should also be prepared from an examination scrutiny standpoint during the pandemic to emphasize fair lending. The year is already over halfway over, and it is readily apparent that the financial impact and consumer relief may carry on to the next.

Tim Dominguez serves as Associate General Counsel for Compliance Alliance, joining C/A after graduating from the University of Houston Law Center. During law school, he worked as an intern within the legal department of Frost Bank in San Antonio, TX. He also holds a Bachelor of Science in Communication Studies from The University of Texas at Austin. Before law school, Tim worked various jobs within the Texas state government, including the Texas Senate and the Texas Legislative Council. As one of our hotline advisors, Tim guides C/A members on a wide variety of regulatory and compliance issues, in addition to writing articles for our publications.

Municipal Credit Update:

2020 Financial Performance Better Than Expected

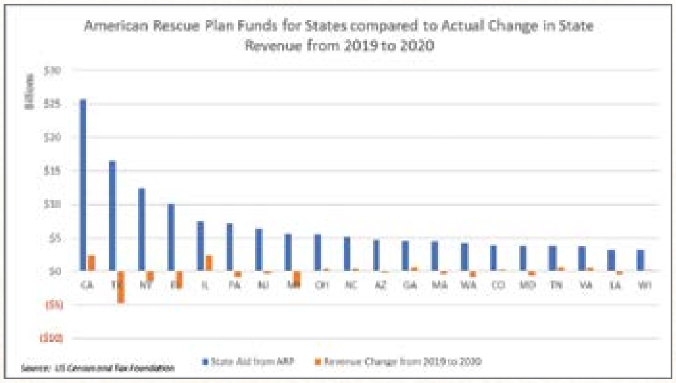
Dana Sparkman, CFA, Senior Vice President/Municipal Analyst, The Baker Group's Financial Strategies Group

AT THE ONSET OF THE COVID-19 PANDEMIC IN THE UNITED States, strict shutdowns and stay-at-home orders created concern for the economy and municipal finances. Forecasts for tax revenue were bleak with anticipated double-digit declines, and many state and local governments braced for a serious financial blow by adjusting budgets, cutting expenses, and delaying non-essential projects. More than a year has passed since the beginning of the pandemic, many governments have published financial statements that include at least a portion of the pandemic, and we now have much more data about how the pandemic has affected municipal credit quality.

Interestingly, tax revenues did not fall near as much as expected. Total state tax revenue was down by almost 1% in 2020 versus 2019 according to U.S. Census data, which was much less than originally feared, and half of states actually had an increase in their total tax revenue. Property tax revenue grew by about 4.1% on average, but general sales taxes and special sales taxes declined by 1.6% and 3.5%, respectively. Zillow reports that average home values across the U.S. increased by 13.2% over the past year. So, although property tax trend changes tend to lag economic changes, property tax revenue – the main revenue source for most local governments – may not be negatively affected by the pandemic.

The CARES Act in 2020 supported consumer spending, and thereby sales tax revenues, with $290 billion of payments to consumers and $270 billion in expanded unemployment benefits. According to the Bureau of Economic Analysis, transfer payments to individuals were the main reason personal income increased by 6.1% in 2020 despite very high unemployment. The CARES Act further boosted municipal revenues in 2020 by providing $150 billion directly to state and local governments, and the American Rescue Plan (ARP) Act, passed in March 2021, provided another $350 billion to state and local governments, which will help to strengthen municipal credit quality in the 2021 fiscal year as well. Of the $350 billion designated for state and local governments, $195 billion was allocated for states, which is over 30 times the aggregate decline in tax revenue from 2019 to 2020. However, some states may experience greater declines in tax revenue in 2021, given that most of the pandemic occurred during the 2021 fiscal year rather than the 2020 fiscal year. Exhibit 1 breaks down the comparison of 2020 tax revenue changes and ARP Act funding by state for the largest 20 recipients of the ARP funds.

Exhibit 1



Over 90% of transportation bonds, 40% of higher education, and 20% of states had a negative outlook or experienced a downgrade by S&P during 2020, but that trend seems to have reversed so far in 2021. S&P revised the outlooks of general Public Finance sectors such as states, local governments, and school districts from negative to stable in early 2021. Also, during the first five months of 2021, Connecticut was upgraded by S&P; Alaska, New Mexico, Oklahoma, and Illinois all had outlooks revised from negative to stable by S&P; and The Baker Group's clients experienced 1.6 upgrades for every downgrade in the first five months of 2021 compared to 0.77 upgrades per downgrade in 2020.

Despite all this good news about the credit quality of the muni market broadly, some specific issuers did struggle. According to Bloomberg data, there were $2.1 billion of defaults during 2020 (0.05% of the $3.9 trillion municipal market) and an additional $4.5 billion that was considered distressed compared to only $1.4 billion of defaults in 2019 and an additional $1.7 billion that was distressed. Of the 2020 defaults, 53% were issuers in the healthcare industry and 29% were deals related to special development purposes. So far in 2021, over half the defaults are once again in the health care industry. Notably, none of the defaults in 2020 or 2021 were general obligation or essential purpose revenue bonds.

The positive news generally seems to outweigh the negative, but investors should not let their guard down yet. General obligation bonds and essential purpose revenue bonds continue to prove resilient, but other types of revenue bonds remain vulnerable.

Dana Sparkman, CFA, is Senior Vice President/Municipal Analyst in The Baker Group's Financial Strategies Group. She manages a municipal credit database that covers more than 150,000 municipal bonds, providing clients with specific credit metrics essential in assessing municipal credit. Dana earned a bachelor's degree in finance from the University of Central Oklahoma as well as the Chartered Financial Analyst designation. You can reach Dana at 405-415-7223 or dana@GoBaker.com.

How Community Banks Can Prepare for CECL Changes

Risk Management Solutions Group

The FASB's new credit loss model is one of the most significant accounting changes in recent history. The time to act is now – here is how you can prepare and comply.

In June 2016, the Financial Accounting Standards Board (FASB) issued a new expected credit loss accounting standard, which introduced an updated method for estimating allowances for credit losses. The Current Expected Credit Losses methodology (CECL) applies to all banks, savings associations, credit unions and holding companies.

If your institution has not yet adopted CECL, now is the time to refresh yourself on the fundamental changes and – most importantly – to start planning.

What is CECL?

The impairment model introduced by the CECL standard is based on expected losses rather than incurred losses. With that, an entity recognizes its estimate of lifetime expected credit losses as an allowance. CECL also strives to reduce complexity by decreasing the amount of credit loss models available to account for debt instruments.

This change was under discussion for many years before its issuance, with the impacts of the global economic crisis highlighting the shortcomings of the Allowance for Loan and Lease Losses (ALLL) framework. FASB concluded that the ALLL approach delayed recognizing credit losses on loans and resulted in insufficient loan loss allowances.

"There are a lot of decisions that need to be made. By starting as early as you can, you avoid any roadblocks in getting CECL implemented by the deadline." – Brian Lewis, RMSG Senior Risk Advisor.

Differences between the previous and the new standards

Previous	New
Loans/leases (could be other valuation reserves)	All debt instruments carried at amortized cost (not those at fair value like AFS securities)
Does not apply to HTM investments	Applies to HTM investments
Threshold = probable loss	Threshold = expected loss
Reporting period focused ("incurred")	Reporting period + forecast ("life of the asset")
Individual assets (specific reserves) + pools at historical loss	Pools of assets with similar risk characteristics + historical loss adjusted for reasonable/ supportable forecast period
Quantitative (data-driven) and qualitative (Q-factors)	Shifts focus to qualitative (adjustments based on reasonable forecasts) + quantitative

How will CECL impact my institution?

Adopting the new standard will influence internal controls and information likely not previously integrated into financial reporting efforts. In other words, the scope of CECL is far-reaching—spanning corporate governance, modeling, credit analysis, technology and others. Additionally, CECL affects all entities holding loans, debt securities, trade receivables and off-balance-sheet credit exposures. In short, it will have significant implications for operations at most financial institutions.

How to proceed toward CECL transition

The time to get started – if you have not already – is now. This is a significant change with extensive effects and potential risks. Careful – and early – planning is critical.

Here are nine key steps institutions can take to take to achieve CECL compliance:

1. Identify functional areas (such as lending, credit review, audit, management, and board) that need to participate in the transition project/implementation and ensure those working in these areas are familiar with the new standard
2. Determine your effective date and whether to adopt early
3. Make a project plan and timeline
4. Discuss the plan and progress with all stakeholders as well as your regulator
5. Determine the ACL estimation method/methods that may be used
6. Identify available data and any other data that may be needed
7. Identify potential system changes
8. Evaluate and plan for the potential impact on regulatory capital
9. Have a straightforward, well-understood process

Finally, it's necessary to take a holistic view to ensure a smooth transition, including:

- Built-in testing for data integrity and method estimation validation
- Update other bank policies and reports so they are consistent with processes
- Consider running parallel with the ALLL to evaluate risks
- Back-test as part of supporting modifications and improvements

What are the implementation timelines?

This standard was effective for many institutions by Dec. 2019, and all others will need to comply by March 2023. These dates are based on the Public Business Entity (PBE) status for institutions. Early adoption was allowed for any institution after Dec. 2018.

Contact us for a complimentary and confidential risk management consultation at 866.825.6793 or riskmsg.com.

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EDUCATION CALENDAR

Please visit nebankers.org/education.html or call the NBA Education Center at 402-474-1555 for the most current event schedule.

AUGUST 2021

School of Trust & Financial Services
August 23-27
Manhattan, KS

New Account Documentation and Compliance Workshop
August 24
Kearney, NE

Advanced Trust School
August 24-26
Manhattan, KS

New Account Documentation and Compliance Workshop
August 25
Lincoln, NE

SEPTEMBER 2021

Fall Agri-business Conference
September 2-3
Lincoln, NE

Bank Compliance School
September 13-17
Manhattan, KS

Essential Teller Issues Seminar
September 14
Virtual Offering

Fall IRA Advanced Workshop
Virtual Offering

Fall IRA Essentials Workshop
September 20-21
Virtual Offering

Fall IRA Advanced Workshop
September 22-23
Virtual Offering

OCTOBER 2021

NBA Convention "Lite"
October 6-7
Lincoln, NE

Advanced Schools of Banking, Year 1
October 4-8
Grand Island, NE

Women in Banking Conference
October 27-28
La Vista, NE

Regulatory Issues Summit
Virtual Offering

For more information about these live and online education events and training tools, contact the NBA Education Center at (402) 474-1555 or nbaeducation@nebankers.org. You also may visit the NBA website at nebankers.org/education.html.

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NBA Nebraska Bankers Association
233 South 13th Street, Suite 700
Lincoln, NE 68508

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