

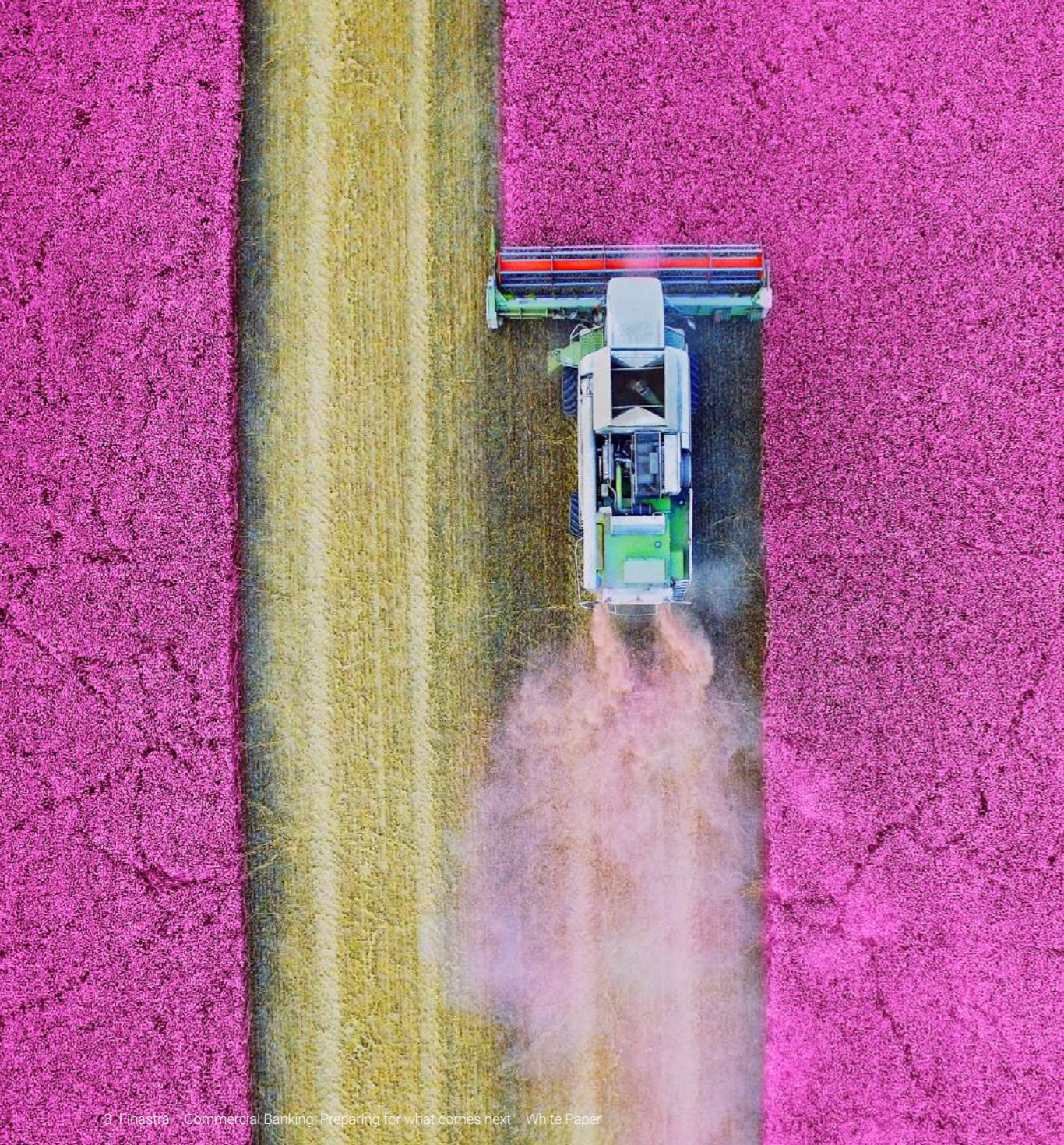


# Commercial Banking: Preparing for what comes next



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## Introduction

**The COVID-19 pandemic is likely to have a long-lasting impact on the American psyche.**

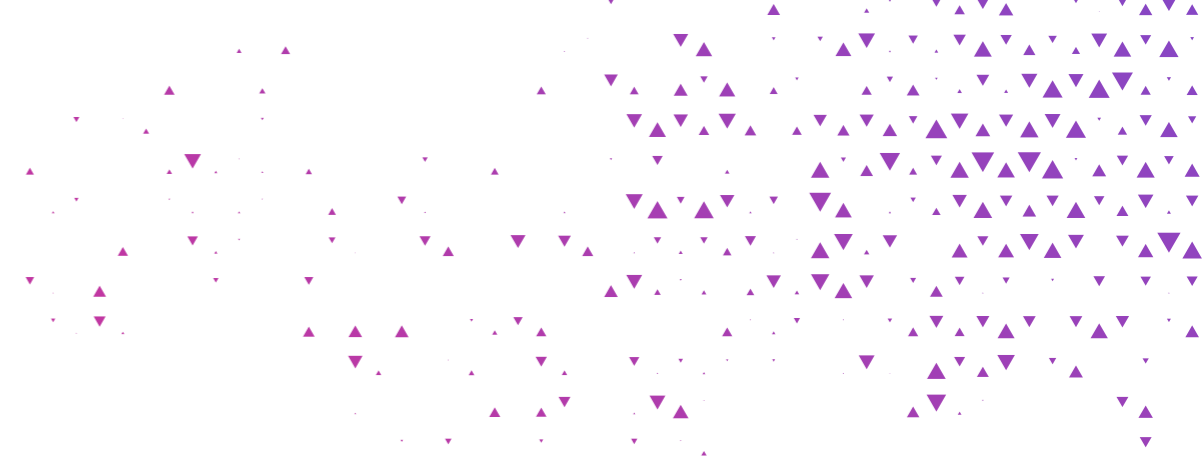
It's the first time in recent memory that an invisible invader has breached national shores and threatened not only the country's financial stability, but our way of life.

As the virus subsides and Americans resume normal routines, businesses will face a challenging future as they recover from the impacts of the COVID-19 crisis. In this post-pandemic world, community banks and credit unions will play a primary role in the recovery and in preparing businesses for what comes next.

Contained in this e-book are nine chapters dedicated to the situation financial institutions and American businesses face, as well as the solutions that community banks and credit unions can provide to help commercial entities return to profitable operations in the months to come.

# How government aid will change the banking landscape

Given the tremendous impact of the COVID-19 pandemic on a wide range of businesses and industries, a government stimulus plan was signed into law by President Trump on March 27.



Over \$800 billion of the \$2 trillion federal aid package, known as the CARES Act, has been set aside to aid commercial entities impacted by the COVID-19 crisis.

Many provisions in the CARES Act were designed with small businesses in mind, bringing together the 1,800 SBA-approved lenders to help SMBs stay afloat. Most notably, \$350 billion in forgivable loans is being provided to cover payroll costs through the Paycheck Protection Program. Additional grants and low interest loans are also available.

While provisions like these will help many small businesses, the Federal Reserve also announced the Main Street Lending Program on April 10 to support mid-sized firms suffering from COVID-19 related impacts. The Main Street Lending Program will make \$600 billion in loans available to businesses with up to 10,000 employees or as

much as \$2.5 billion in 2019 revenues.<sup>1</sup> It is the first time since the 1930s that the Fed has attempted to offer this kind of direct-lending program.

Despite these drastic actions, it has quickly become clear that initial federal stimulus plans will not be enough to support a commercial environment troubled by lengthy shutdowns and declining consumer interest.

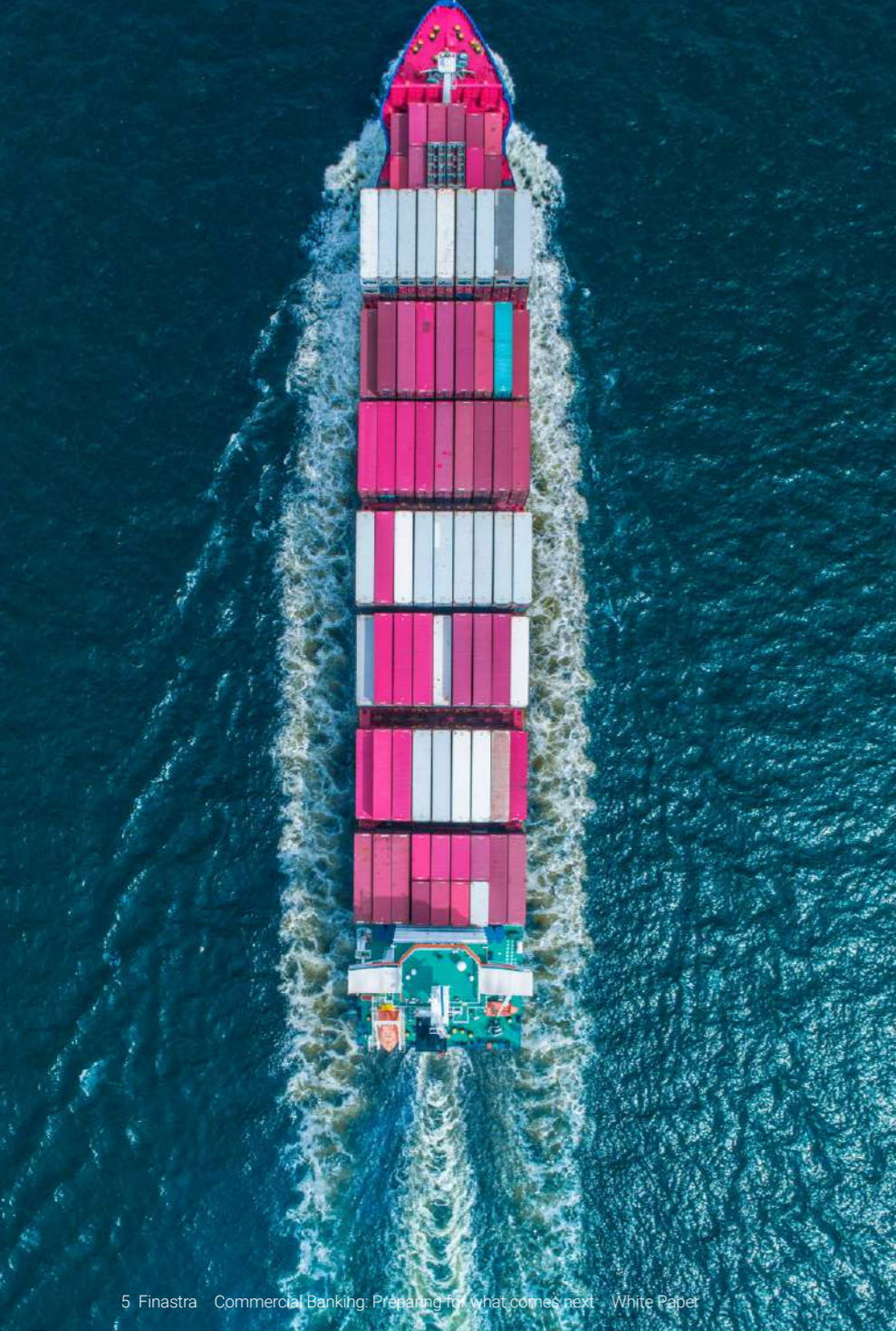
According to Glen Hubbard, professor of economics and finance at Columbia University and chairman of the Council of Economic Advisers under President George W. Bush, initial paycheck protection funds were inadequate to support the number of businesses impacted by COVID-19. He also posits that the economy will require another jolt of federal aid over the long term to boost business confidence in the post-pandemic environment.

In this situation, community banks and credit unions will be in the hot seat, requiring a prioritized waterfall approach to deliver the financial assistance businesses will need in the coming months and possibly years:

- **Lending Officers**  
In the near term, lending officers should proactively identify eligible clients and notify them of applicable government programs, always with an eye toward preserving the credit standing of their loans. Over the long term, it will be necessary to communicate through credit channels to address the challenges their clients are facing and how they are handling them.
- **Credit Officers**  
Credit Officers face the monumental task of re-underwriting nearly all loans and borrower ratings according to the offsetting influence of COVID-19 forces on individual borrowers.

- **Chief Financial Officers**  
CFOs will have more than profitability on their minds as they adjust capital and leverage ratio forecasts according to evolving portfolio adjustments. They will also need to address CECL forecasts, models and assumptions.
- **Treasurers**  
Treasurers will need to review funding and liquidity projections in light of Federal programs to keep pace with new funding requirements, such as those associated with PPP loans and draws on committed lines.

Without this approach, community banks and credit unions may not be able to help clients through this troubling time and could very easily miss the mark on tracking the evolving credit or capital impacts. Fortunately, digital tools are available to simplify associated processes to ensure that community banks and credit unions are able to support and strengthen client relationships for years to come.



## Coronavirus, a pandemic-sized problem for CECL compliance

On March 27, 2020, the proposed federal stimulus package, known as the CARES Act, included a temporary delay on CECL compliance due to the evolving impacts of the pandemic. Despite the substantial regulatory capital relief provided, CECL capital compliance remains an inevitable and mandated challenge for many community lenders.

However, when the current reprieve comes to an end, projecting the capital impact of the sudden economic shock from COVID-19 on Current Expected Credit Losses (CECL) will require lenders to simultaneously model specific credit impairment to borrowers, as well as offsets from federal or state assistance programs and an evolving view for whether a recovery is V-shaped, U-shaped or L-shaped. To add to the complexity, these variables will undoubtedly evolve over time, causing unprecedented capital volatility from quarter to quarter as projections swing over the life of a loan portfolio.

For financial institutions and other businesses that must conform to CECL requirements, analytics are one of the most powerful tools for helping to ensure adequate capital reserves and to communicate CECL capital compliance to boards, shareholders, regulators, accountants and other important constituents.

Here are the primary points to consider when adopting an analytics solution to help maintain CECL compliance:

- 1 Look for flexibility supported by multiple loss estimation methodologies and qualitative adjustments on a quarter-by-quarter basis.
- 2 Ensure solutions can support the five loss methodologies mentioned by The Financial Accounting Standards Board (FASB), the FDIC and the Federal Reserve Board of Governors (FSB), including Vintage, Loss Rate/Roll Rate, Probability of Default x Loss Given Default (PD x LGD), Weighted Average Remaining Maturity (WARM) and Discount Cash Flow (DCF).
- 3 Look for the ability to support Qualitative Factors (Q-factors), manual adjustments to loss estimations based on unmodeled dynamics or one-time severe events, such as a coronavirus pandemic. Q-factors have a substantially greater impact under CECL for shock events like this when historical loss rates become less predictive of future results.
- 4 Avoid double counting stress projections within a stress event. Banks may have already factored in certain related scenarios, such as possible spikes in unemployment, in current calculations.
- 5 Given the complexity of loss reporting against the looming quarter deadline, having a rapidly deployable analytics solution, able to accept loan information from any core loan system, is therefore essential to community financial institutions as they grapple with first quarter projections.

# The looming LIBOR transition

## LIBOR transition efforts push forward during pandemic.

Historically, the London Interbank Offered Rate (LIBOR) has been in use to set interest rates for up to \$350 trillion in financial instruments,<sup>2</sup> but in 2017, the U.K. Financial Conduct Authority announced the phaseout of LIBOR.

In 2021, most lenders are expected to begin transitioning away from LIBOR to the Federal Reserve's preferred substitute, the secured overnight financing rate, or SOFR. However, the COVID-19 pandemic has introduced several impediments to a transition timeline that many experts felt was already ambitious.

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***I think for the minute detail of transition, and for the less frequent users of interest rate products, it makes things even more difficult if we're not able to meet face to face and talk about these problems."***

**Antoine Bouvet**

Head of interest rate strategy, ING

**For lenders, here are the latest developments on the LIBOR transition in the wake of the COVID-19 pandemic.**



- Following the Federal Reserve's move in March to add an extra \$50 billion to overnight repo operations and a promise to offer trillions of dollars in funding, the spread between LIBOR and SOFR-linked interest rate swaps climbed.



- On March 12, 2010, The Financial Accounting Standards Board issued optional relief for lenders undergoing the transition away from LIBOR, preserving hedge accounting when a contract is modified and during the temporary transition period, as long as amounts owed to the hedge provider remain visible in financial statements.



- Many experts view the current economic volatility resulting from the COVID-19 pandemic as a way to scrutinize the soundness of SOFR during crisis. Since SOFR is a forward-looking benchmark, based on the U.S. Treasury bonds posted by the financial lender as collateral, the trending of the U.S. treasury yield curve close to zero in March is offering a baptism by fire for SOFR.

As a result of these developments, several LIBOR specialists are pushing for a delay in the current 2021 transition deadline to give lenders time to adjust to the impacts of the current COVID-19 pandemic. However, it is advisable for commercial lenders to continue transition efforts if and where possible.



## The customer challenge, how businesses will change in the year to come

### Long-term closures lead to increased jobless rates and decreased spending.

Empty grocery store shelves, shuttered restaurant dining rooms and work-from-home edicts in several states have changed the bustling face of American business. While many long for a pre-pandemic world, others have benefitted from the chaos, as demand for products and services soars.

However, long-term closures promise to take their toll on all, as jobless rates rise and unemployment claims soar. On March 20, California governor, Gavin Newsom, reported 80,000 unemployment claims in a single day.<sup>3</sup> Other states were impacted likewise, with 72,000 claims in Connecticut<sup>4</sup> and 100,000 in Minnesota to end the week of March 20.<sup>5</sup>

Layoffs could result in reduced spending as consumers pull back on purchasing elective items in favor of taking care of essentials, such as housing and food. By March 21,

several Wall Street firms, including Goldman Sachs, Deutsche Bank, JP Morgan, and Bank of America were predicting a recession in the very near future and a decline in U.S. gross domestic product.

President Trump, on the other hand, has remained optimistic, promising during an address on March 20 that “our country is going to bounce back like you’ve never seen before” provided stimulus packages under consideration at the time included protections for businesses as well as workers.

A look at the economic impacts of 9/11, would seem to support the president’s view, revealing a remarkably resilient population. In just 1 year following the terrorist attacks, U.S. GDP rebounded over the previous year more than 1 percent,<sup>6</sup> while markets gained 5,000 points over the next 6 years.<sup>7</sup>

By many accounts the tragedy was one of human proportions more than economic.

The post-pandemic truth, however, could be more nuanced than the impact of 9/11, as hits to American business, and thus the economy, will be sharper the longer social distancing remains in effect. Even in the absence of government mandates, many citizens will continue to remain behind closed doors or at the very least, limit contact, until the disease shows signs of being eradicated.

For businesses, the next eighteen months will be a time of recovery and restoration, and while no one should expect immediate rebounds, impacts for the hardest-hit industries are likely to be more severe and last for longer.

# Travel industry and food services, first hit equals hardest hit

Swift impacts may have long term recovery.



**The travel industry was the first to feel the brunt of COVID-19, and the results were swift and severe:**

- By the beginning of March, the U.S. hotel industry had erased February gains as occupancy fell 7.3 percent.<sup>8</sup> Average daily rates were down over 4 percent as well.<sup>9</sup>
- On March 25, 2020, airlines, possibly the hardest hit, received a federal aid package. The \$58 billion deal is split equally between grants and loans and requires airlines to share dividends for at least a year.
- Following closures of many of its iconic theme parks, Disney raised almost \$6 billion in a debt offering to cover COVID-19 related impacts and warned investors of possible future implications “should the disruptions from COVID-19 lead to changes in consumer behavior”.<sup>10</sup>

If consumer reaction to 9/11 is any indication, Disney’s warning to shareholders could be one for the industry at large.

In the wake of 9/11, the travel industry remained sluggish for years. Airlines, for example, lost money in 7 of the next 10 years following the attack and only offset cumulative losses by \$30 billion from the three profitable years.<sup>11</sup>

Depending on how long fear from the coronavirus pandemic persists, the travel industry could see another long-term recovery period in its future.



Restaurants, another of the first businesses to feel the brunt of COVID-19 , will likely fare better once social distancing and shelter-in-place restrictions end, but may have major losses to overcome. Since March 10, 2020 when states began closing public eateries to all but takeout, restaurants have realized a 91 percent decline in business, according to studies conducted by OpenTable.<sup>12</sup>

Offering aid to both the travel and restaurant industry through low-interest loans has been supported by government officials on both sides of the aisle through the CARES Act, providing community banks and credit unions with a major role to play in supporting local businesses impacted by COVID-19.



## Community banks and credit unions, the essential resource for small businesses in the wake of COVID-19

The next eighteen months will be critical for business recovery.

As of April 3, 2020, forty six states had mandated that all non-essential businesses shutter their doors. The impact could be devastating for many SMBs that operate on a shoestring budget.

Across America, there are more than thirty million small businesses,<sup>13</sup> according to the SBA. If just 10 percent were to close in the aftermath of the pandemic, the resulting loss of three million companies would send a shockwave across the country's economy.

However, in this environment, community banks and credit unions can play a prominent role in helping small businesses survive over the next eighteen months:

- **Support small businesses now:** While many businesses, such as restaurants and small retailers, are able to continue serving customers on a limited basis, they are not generating the income required

to support the business over the long term. One way that community banks and credit unions can help SMBs now is by using mobile banking apps and online portals to list those local entities that are open, as well as the services they continue to provide.

- **Offer loan payment deferrals and fee suspensions:** For struggling businesses, an offer to defer loan payments during the COVID-19 pandemic, with no fees or impact to the company's credit score, can provide the relief necessary to keep the business in operation.
- **Waive credit card fees:** Many small businesses rely on credit cards to pay for business services, but in the wake of COVID-19 interruptions, may not be able to pay balances in full. Banks and credit unions can offer good will by suspending late and over limit fees for businesses

who cannot pay balances on time or need additional cash to remain afloat.

- **Offer to defer interest:** While offering to defer loan payments provides SMBs with breathing room, deferring interest may do more to help business owners recover from the impacts of COVID-19. This can be done on a case-by-case basis or under blanket statements, covering an industry or any business required to close its doors or limit services during the pandemic.
- **Be proactive:** Much of the federal aid for small businesses in the government's stimulus package will come through the Small Business administration's 7(a) program, supported by 1,800 community lenders.<sup>14</sup> To help SMBs remain afloat in this difficult time, community banks and credit unions should consider using analytics to identify at risk companies and reach out to discuss options.

# Why a lack of digital adoption could hurt commercial lenders and SMBs

As businesses bounce back from the impacts of COVID-19, commercial lenders will play a large role in their recovery.

// *Small businesses are not well served by traditional financial institutions, nor will existing federal small business loan programs deliver funds soon enough...Any federal small business loan program must leverage digital advances in the marketplace to ensure that stimulus can reach those businesses most in need."*

Financial Innovation Now  
Letter to Congress, March 20

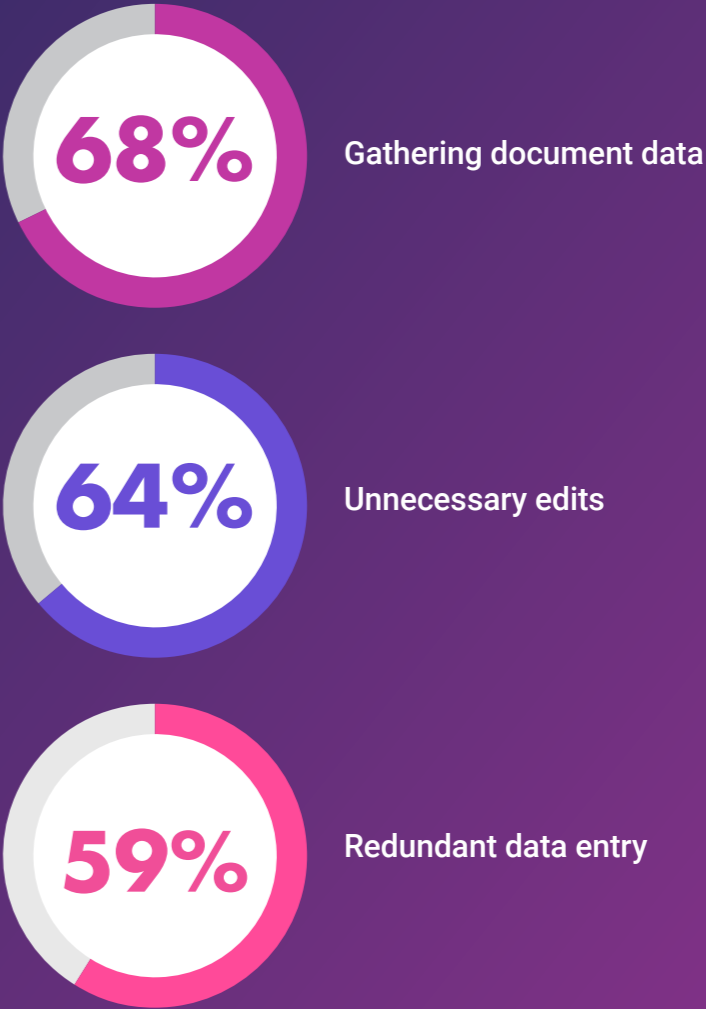
However, the slow adoption of digital capabilities by many financial institutions could hamper the ability of small- and mid-sized businesses to respond to their financial challenges, as an escalating number of loan requests will easily overrun manual processes and operations.

According to research conducted by McKinsey, the average time to decision for corporate lenders is three to five weeks, while businesses must wait three months to receive a payout.<sup>15</sup> In the wake of the COVID-19 pandemic, waiting three months for a cash payout could bury many small- to mid-sized businesses, particularly if consumers remain sluggish in their return to shopping and spending.

Meanwhile, online lenders are stepping up for a piece of the government stimulus plan. On March 20, 2020, Financial Innovation Now, an industry group representing online non-bank finance companies, such as Square, PayPal and Stripe, issued a letter asking members of Congress to include them in any emergency funding packages issued by the U.S. government.

Fortunately, third party technology providers can offer rapid deployment and integration with existing lending systems to help community banks and credit unions be ready for what comes next—helping businesses recover from the devastating financial consequences of the COVID-19 pandemic.

In addition to the fourteen percent of simple loans that require rework and the thirty-six percent of complex loans that require rework, bottlenecks in critical areas of traditional lending are under extra pressure:<sup>16</sup>





# Promoting business as usual with electronic signatures

Banks and credit unions opened 2020 with a dedicated focus on developing digital capabilities.

It was the number 1 concern cited in BAI's Banking Outlook Survey, replacing the need for deposit growth, 2019's top priority.<sup>17</sup>

In the world of COVID-19, failing to obtain electronic signature capabilities as part of a digital strategy could do more than hurt customer satisfaction. It could limit opportunities if business owners cannot or will not meet in person to sign documents.

Here are four ways that electronic signatures can be used during the pandemic, and beyond, to serve commercial customers and members.



**1. Account Opening:** Seventy percent of business owners say they would prefer to open a new deposit account online.<sup>18</sup> Preferences could easily turn to necessity, however, during the COVID-19 pandemic. Electronic signature capabilities make it possible for business customers to open accounts online without the need to visit a branch to sign documents.



**2. Lending:** Many businesses will rely on loans to remain stable during the COVID-19 restrictions and the recovery process. Shelter-in-place directives will make it difficult to gain the financial assistance they need, if banks are not able to support a wholly digital loan process that includes the ability to accept and process e-signatures. Even as life returns to normal, business owners are apt to be focused on putting their operations back on track and will therefore prioritize lenders that can streamline the loan origination life cycle.



**3. ACH processing:** Social distancing restrictions will require businesses to rely more on digital processes for making payments. E-signature capabilities enable businesses to sign off on bank authorization forms remotely.



**4. Treasury Management:** During the COVID-19 pandemic and beyond, businesses could easily increase adoption of treasury management services to improve receivables management and liquidity. Electronic signature capabilities will onboard businesses faster while eliminating the need for in-office visits.

## The financial impact on financial institutions

With an uncertain economic outlook for the near term, financial institutions could see a challenging road ahead.

In a fickle economy, reduced demand for banking products and services, combined with the aggressive rate action taken by central banks, will likely challenge interest income over the next year. Additionally, many community banks and credit unions have incurred added costs associated with moving workforces to remote working situations.

Ultimately, as banks and credit unions look toward the future, being ready for what comes next means finding ways to boost noninterest income and tightening the belt on unnecessary expenditures:

- Distribution accounts for sixty-five percent of banking costs. To reduce expenditures, Accenture recommends that financial institutions streamline back-office and IT operations, freeing cash for front-office efficiencies, such as self-service channels.

- According to Aite Group, now is the time for commercial lenders to expand their receivables capabilities, particularly in the area of commercial cards, an area where nonbank competitors are making inroads. Once that business is lost, Aite predicts, it will be difficult for community banks and credit unions to regain.<sup>19</sup>
- Digitization will go a long way in reducing expenditures while facilitating income. Automating lending cycles, for instance, has been shown to cut costs by 20 percent while still supporting growth,<sup>20</sup> giving banks more leverage in a low-rate environment.
- Another plus on the side of digital adoption is data. The rich data streams generated from digital banking activities provide commercial banks and credit unions with the power to identify areas ripe for cost containment.

- Open banking APIs are a light on the banking horizon, allowing community banks and credit unions to offer third-party products to customers and members, generating revenue from a stream of brand-new services. Look for Fintech providers capable of supporting your current processes and vendors as well as new ones.

# THE FUTURE OF FINANCE IS OPEN

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### North American Headquarters

744 Primera Boulevard  
Suite 2000  
Lake Mary, FL 32746  
United States  
T: +1 800 989 9009

