P&G Banking

ADVISOR

Spring 2009

Why ERM?
Enterprise risk management on critical upswing

Commercial real estate
De-stressing with stress testing

6 ways to close the technology gap

Uncover cash sources with cost segregation

P&G Associates
Outsourced Internal Auditors and Consultants

www.pandgassociates.com 877.651.1700

Uncover cash sources with cost segregation

The economic downturn has been hard on all businesses, including many community banks, so it's important to explore all of the options available to improve your cash flow. One tool you should consider using is the cost segregation study — particularly if you plan to acquire new branches or other banking facilities, or if you've done so in the last few years.

Stepping up depreciation

Using engineering and tax accounting principles, a cost segregation study identifies building components that qualify for accelerated depreciation. This enables you to slash your tax bill or claim a refund for missed depreciation deductions in previous years.

Cost segregation studies are particularly valuable in the banking industry and yield a relatively high percentage of cost reallocations. That's because bank buildings typically contain many components that could be properly classified as personal rather than real property. In addition to acquired buildings, these benefits also may be available for new construction or for substantial improvements to existing facilities.

Deconstructing your property

Generally, commercial real estate is depreciated over 39 years. The 39-year recovery period applies to *real* property, which includes buildings as well as structural components, such as walls, windows, ceilings and HVAC systems. But the 39-year recovery period doesn't apply to personal property, such as furniture, computers, ATMs, copiers and communications equipment, which are generally depreciated over five or seven years.

A cost segregation study enables you to slash your tax bill or claim a refund for missed depreciation deductions in previous years.

Cost segregation studies focus on building components that appear, at first glance, to be real property, but are more accurately classified as personal property depreciable over five or seven years or as land improvements depreciable over 15 years. The IRS and the courts examine several factors to determine the proper classification of an item, including whether it's affixed to the building or land and whether it's intended to remain in place permanently. They also consider whether the item can be removed easily without damage and whether its function is more closely related to the operation of the building or the owner's business activities.

The last factor is particularly relevant to banks. Bank buildings contain specialized structures and building components that are unique to providing banking services and, therefore, often can be classified as personal property. Examples include bank vault doors, bank record doors, night depository facilities, walk-up and drive-up teller's windows, and pneumatic tube systems.

Savings you can realize

Suppose a bank acquires a branch for $10 million in June 2009. The bank conducts a cost segregation study on the facility and, as a result, allocates $1.5 million of the purchase price to five-year property, $500,000 to seven-year property and $1 million to 15-year property.

The chart below shows how shifting costs to assets with shorter recovery periods generates almost $380,000 in additional depreciation deductions in the first year alone.

	Without cost segregation		With cost segregation	
Asset class	**Cost**	**First year depreciation**	**Cost**	**First year depreciation**
39 years	$ 10,000,000	$ 139,100	$ 7,000,000	$ 97,370
15 years	$ 0	$ 0	$ 1,000,000	$ 50,000
7 years	$ 0	$ 0	$ 500,000	$ 71,450
5 years	$ 0	$ 0	$ 1,500,000	$ 300,000
Total	$ 10,000,000	**$ 139,100**	$ 10,000,000	**$ 518,820**

Source: IRS Publication 946, How To Depreciate Property, *Tables A-1 and A-7a*

By conducting a cost segregation study, the bank generates an additional $379,720 in first-year depreciation deductions ($518,820 - $139,100). Assuming a combined marginal tax rate of 40%, this translates into first-year tax savings of $151,888 ($379,720 x .40).

Other items that banks may be able to classify as personal property, but that aren't limited to the banking industry, include:

- Electrical connections and wiring for specialized equipment, such as ATMs, computers, copiers and televisions,
- Telephone system and connections,
- Removable partitions,
- Removable wall and floor coverings,
- Removable awnings and canopies,
- Window treatments,
- Decorative lighting and millwork, and
- Internal and external signs.

Land improvements depreciable over 15 years might include items such as parking lots, sidewalks, exterior lighting, fences, gates and signs affixed to the land.

Capturing the benefits

The benefits of a cost segregation study can be substantial. Although every bank is different, an often-cited rule of thumb says that, for each $100,000 of assets reclassified from 39-year property to five-year property, a bank could enjoy a net present value savings of about $22,000 (assuming an 8% discount rate and a 40% marginal tax rate). For an example of the potential benefits, see "Savings you can realize," above.

If you conduct a cost segregation study in connection with the acquisition of a branch or other property, you can claim the benefits of accelerated depreciation beginning with your tax return for the year you acquire the property. If you use a cost segregation study to support accelerated depreciation for prior years, you'll need to apply for a change in accounting method under the IRS's automatic consent procedures. In most cases, you can claim the missed depreciation deductions on the current year's income tax return without amending your previous returns.

Boosting your cash flow

Any time your bank acquires, constructs or substantially renovates a building, consider conducting a cost segregation study. By allocating the maximum cost permissible to assets with shorter useful lives, you can increase your depreciation deductions, reduce your tax bill and give your cash flow a much-needed boost. ▲

Why ERM?

Enterprise risk management on critical upswing

Risk is good. In fact, it's the very foundation on which the business world is built. Without risk, there are no rewards. That's why we talk about "risk management" rather than "risk elimination."

For banks, the goal of risk management is to understand the risks associated with various banking activities and maintain an acceptable level of risk that's justified by the potential rewards. More and more, enterprise risk management (ERM) is being recognized as an effective tool for banks of all sizes. And with regulators scrutinizing banks' risk management programs, now is an ideal time to explore its benefits.

Employ a simple concept

Although implementing ERM can be complex, the concept is surprisingly simple. Traditional risk management approaches examine risks — including interest rate, credit, liquidity, operational, market, legal, technology and reputation — in separate "silos." ERM takes a more holistic approach that looks across departmental and functional lines to assess the impact of various risks on the organization as a whole and better align risk management with a bank's strategic plan.

ERM provides a more realistic picture of the bank's risk because it recognizes that the impact of negative events in one area may reverberate to other areas throughout the bank. It also recognizes that in some cases risk in one area may be *too low.* Consider these examples:

ABC bank evaluates its credit risk based on potential losses from defaults on loans. If the bank had applied ERM, however, it would have taken into account the risk that multiple defaults also would damage its reputation, leading to additional business losses beyond the loans in question.

XYZ bank, on the other hand, is so focused on minimizing its credit risk that it turns away lucrative lending opportunities, which hurts its profits. An ERM system balances risks against rewards, recognizing that an appropriate risk level is essential to a profitable business.

By taking enterprisewide risks into account, ERM enables management to make better informed risk management decisions.

Develop a framework

In 2004, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published *Enterprise Risk Management — Integrated Framework*, which identifies the key components of an ERM program:

- Internal environment — including risk management philosophy, risk appetite, integrity and ethical values,
- Objective setting — setting objectives and ensuring that they support and align with the bank's mission,
- Event identification — identifying internal and external events that affect the bank's achievement of its objectives,
- Risk assessment — analyzing risks, including their likelihood and impact,
- Risk response — developing a set of actions to align risks with the bank's risk tolerance,
- Control activities — establishing and implementing policies and procedures to help ensure that risk responses are effectively carried out,

- Information and communication — identifying, capturing and communicating information so that people are able to carry out their responsibilities, and
- Monitoring — monitoring and, if necessary, modifying the ERM program on an ongoing basis.

For more information about the COSO framework, see www.coso.org/ERM.htm.

Build a profitable enterprise

ERM is a powerful tool that can help your bank develop a more accurate picture of enterprise risks. This information can be used to evaluate strategic alternatives, develop appropriate responses to various risks, minimize unexpected losses, improve the deployment of capital and make the most of your opportunities. ▲

Commercial real estate

De-stressing with stress testing

Headlines about the financial crisis tend to focus on the subprime mortgage collapse, but the impact of the crisis on the banking industry has spread well beyond residential lending. The biggest area of concern is commercial real estate (CRE) lending.

Many community banks have high concentrations of CRE loans in their portfolios, so it's critical to assess your risk exposure in connection with these loans and take steps to manage that risk.

The next crisis?

The next crisis in the banking industry is likely to involve CRE lending. Although construction and development loans for residential housing projects present the biggest risks, the current economic recession and credit crunch are affecting all types of commercial real estate.

Ironically, the very trend that shielded most community banks from the subprime meltdown also increased their exposure to CRE risk. When large financial institutions began to corner the market on residential loans, community banks turned their attention to CRE lending. As a result, according to the Office of the Comptroller of the Currency (OCC), by 2008, the average concentration of CRE loans at community banks reached approximately 285% of capital, nearly twice as high as it was only six years earlier.

Regulatory concern

Even before the subprime mortgage meltdown, banking regulators had expressed concern about the risks associated with high CRE concentrations. In 2006, for example, the FDIC, OCC and Federal Reserve published interagency guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*.

Any institution that has experienced rapid growth in commercial real estate lending, or exhibits "notable exposure" to certain types of CRE, may be targeted by regulators.

Regulators were concerned not only with banks' heightened risk exposure in the event of an economic downturn, but also because many banks had relaxed their underwriting standards to compete for CRE loans. The guidance focused on banks in which:

1. Total reported loans for construction, land development and other land represent 100% or more of total capital, or
2. Total CRE loans represent 300% or more of total capital *and* the outstanding balance of their CRE loan portfolio has increased by 50% or more during the previous 36 months.

Regulatory scrutiny isn't limited to banks that exceed these thresholds, though. Any institution that has experienced rapid growth in CRE lending, or exhibits "notable exposure" to certain types of CRE, may be targeted.

What's your stress level?

Recently, the OCC broke down community banks into three groups according to their level of exposure to weak CRE loans, and is closely watching the group with the greatest perceived CRE risk. Banks in this group are expected to establish a solid plan for assessing and managing their risk. Regulators also want to see banks stress-test their portfolios and make necessary adjustments, such as reducing their concentration of CRE loans, tightening underwriting standards for new loans, increasing loan loss reserves, or boosting capital.

The interagency guidance urges banks to develop risk management programs that include these key elements:

- Board and management oversight,
- Portfolio management,
- Management information systems,
- Market analysis,
- Credit underwriting standards,
- Credit risk review function, and
- Portfolio stress testing and sensitivity analysis.

Regulators are particularly concerned about the last element. Stress testing uses financial modeling and other techniques to estimate the impact on a bank of certain stresses or "shocks." What would happen, for example, if interest rates went up (or down) by 2%? What would happen if vacancy rates rose or construction costs increased by various amounts? For more information on regulatory concerns, see document FIL-22-2008 on the FDIC Web site (fdic.gov, under "News & Events / Financial Institution Letters").

What works

The key to effective stress testing is to create models that go beyond individual stress factors and examine the potential impact of various combinations of influences. Once you understand your portfolio's ability to withstand these stresses, you can identify risk mitigation strategies that will help cushion the blow. These include adjusting capital allocation levels, reducing your concentration of high-risk loans and beefing up your underwriting standards.

Unfortunately, many community banks fail to give stress testing the attention it deserves. In testimony last year before the Senate Committee on Banking, Housing and Urban Affairs, Comptroller of the Currency John Dugan expressed concern about inadequate stress testing by banks. Dugan observed that, "despite our previous guidance, a number of banks with CRE concentrations have not extended their stress testing of income-producing properties beyond interest rates to other business variables that affect risk, such as vacancy rates, lease rates, and expense scenarios."

Why banks shy away

One possible reason that community banks have been slow to implement stress testing is the misconception that it requires highly sophisticated — and, therefore, expensive — financial models. But depending on your bank's particular risk profile, it may be sufficient to develop a few simple "what if" scenarios that stress two or three variables. You can use these scenarios to test individual loans or groups of loans.

The right strategy for your bank depends on its size and resources, along with the nature and complexity of its CRE activities. The prescribed level of stress testing is driven by a variety of factors, including the extent to which your CRE portfolio is diversified and the level of exposure, in terms of dollars, of various portfolio segments.

As you review your CRE activities, ask what factors might cause borrowers to default on their loans. Then design a stress-testing program that focuses on those factors. Keep in mind that, in evaluating your stress-testing program, regulators will consider your bank's resources. If your resources are limited, it may be acceptable to concentrate your efforts on the areas where you're most vulnerable.

Averting a crisis

One reason that the residential mortgage crisis has been so severe is that many financial institutions, lawmakers and even regulators ignored or at least downplayed the warning signs until it was too late. By evaluating and managing their risks, community banks have an opportunity to avert — or at least mitigate — a similar crisis in the CRE industry. ▲

6 ways to close the technology gap

Most community banks underuse their technology systems. Although the statistics vary depending on whom you ask, anywhere from 40% to 85% of the typical community bank's technology capabilities go unused. And this refers to technology capabilities that are already built into a bank's current systems — not new products.

To buck the trend, all banks should review their systems and look for ways to close this technology gap. Whether you eliminate wasted technology — or find ways to better use what you already have — a technology review can help you enhance your bank's profitability.

Looking in the right places

Following are six areas to examine as you review your technology capabilities. The list is by no means exclusive, but it gives you an idea of where you might uncover hidden opportunities.

1. Unused licenses. Does your core system include more licenses than you need? If so, either start using them or, if possible, return them.

2. Unused or duplicated modules. Your core system may include modules that you've never used or no longer need. Or perhaps you've purchased software from a third party that does a better job of performing the same function.

> A technology review can help you enhance your bank's profitability.

Consider whether you can now benefit from unused modules or, if not, negotiate with your vendor to lower your costs. If you're using another company's software for a function that your core system offers, find out whether your core system vendor has made improvements that would enable you to eliminate the third-party product.

3. Underused functionality. One of the most common ways that banks waste their technology capabilities is by continuing to use manual or paper processes even though the technology they already have can streamline those processes. Consider check imaging, for example. Virtually every bank images checks, but many continue to print those images on paper and mail them to their customers rather than take advantage of the imaging system's ability to support electronic statement distribution.

4. Beyond compliance. Most banks use technology to support customer identification programs and meet their obligations under the Bank Secrecy Act. But all too often, they stop there.

A customer identification program (CIP) helps you collect the information you need to identify "high-risk" customers, but this same information also can be used to improve customer service and identify marketing opportunities. By going beyond mere compliance and incorporating the CIP function into your customer relationship management (CRM) system, you can improve the customer experience by avoiding the need to ask the same questions repeatedly. Integrating your CIP and CRM systems also can help you identify customer needs and recommend the right solutions.

5. Inadequate training. Technology often goes unused because employees continue doing things the old way simply because "that's the way we've always done it." Better training can help employees become more comfortable with technology and demonstrate how it can make their jobs easier and more productive.

6. Obsolete processes. A common mistake that businesses make when implementing new technology is trying to conform the technology to existing processes — regardless of whether they are efficient or effective. As Peter Drucker famously warned, "There is nothing so useless as doing efficiently that which should not be done at all." A better approach is to evaluate your processes and examine ways you can modify them to enhance the benefits technology offers.

Making the most of technology

In today's tough economy, banks need to explore every option at their disposal for reducing costs and boosting revenues. Reviewing your technology system can be a great way to uncover untapped capabilities and help streamline processes, work more productively and improve customer service. ▲

P&G Associates ("P&G") is a professional services Firm specializing in outsourced internal audit services to financial organizations of all sizes. As a high quality, flexible and affordable alternative to national public accounting firms, we have become a leading provider of professional auditing services, including regulatory compliance, BSA/AML and information technology audit services. As a Firm, we have been proactive in assisting our clients with designing, implementing and testing the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

P&G's uniqueness is characterized by its experienced staff and partners. Their hands-on involvement on each engagement provides our clients with a wide range of skills, experience and industry expertise. We employ the use of Subject Matter Experts — designated individuals performing audits in their specific field of expertise. The use of such professionals provides a unique value-added approach that is both efficient and productive.

We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

We pride ourselves in our ability to provide effective and practical solutions that are commensurate with our clients' needs by emphasizing high-quality personalized service and attention. Our services are truly customized.

For **Solutions** *to your internal audit needs, please contact our service coordinators at (877) 651-1700, or log-on to www.pgcpa.com to learn more.*

P&G Associates
Outsourced Internal Auditors and Consultants

www.pgcpa.com

Headquarters:
646 US Highway 18
East Brunswick, NJ 08816

8700 W. Bryn Mawr Ave.
Presidents Plaza II
Suite 800 S.
Chicago, IL 60651

80 S.W. 8th Street
Suite 2000
Miami, FL 33130

877.651.1700