P&G Banking ADVISOR

Summer 2009

Leverage online banking to generate deposit growth

Avoiding "capital" punishment
Maintain adequate capital in today's economy

Dealing with troubled loans

Are your business customers looking to switch banks?

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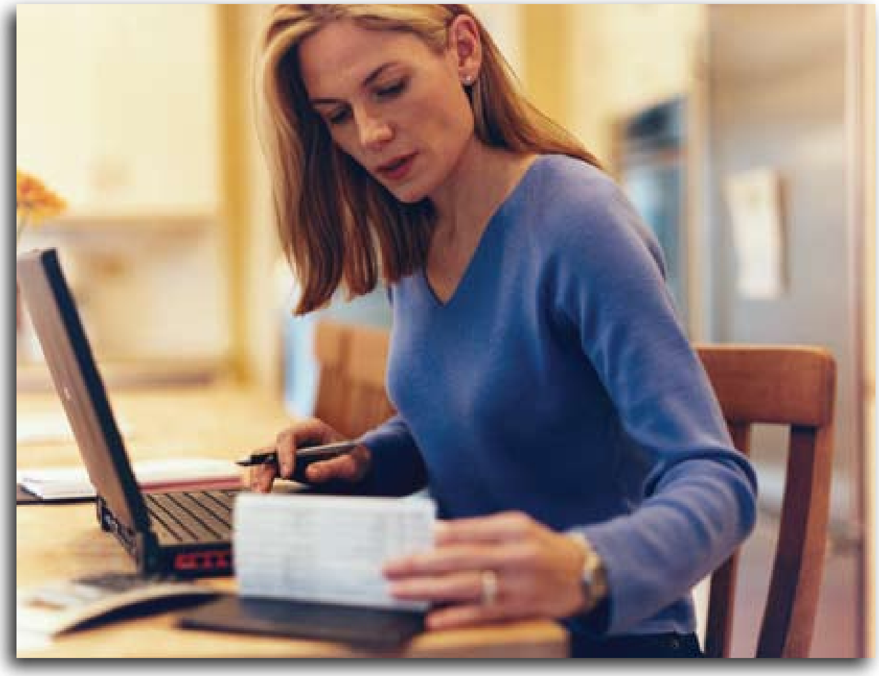

As a byproduct of the current financial downturn, more people are keeping their money in savings accounts and other investments they consider "safe." This presents an opportunity for financially sound banks to attract new deposits. And one way to spur deposit growth is to take advantage of the Internet and other technologies that encourage people to save and make it easier for them to make deposits with your bank.

But although online banking can be a great way to generate new business, it can also increase your bank's exposure to fraud, identity theft, money laundering and other risks. Before you introduce online banking or add new services to your Web site, it's critical to address security issues. You must be sure that you have appropriate internal controls in place to minimize and monitor online risks.

Online tools to consider

There are many tools you can offer existing and new customers that make it easier for them to save. Examples include:

- **Online account opening and funding.** Enabling customers to open accounts from the comfort of their homes and offices can be a powerful tool for attracting deposits.
- **Automatic transfers.** Allowing customers to set up automatic, recurring transfers to a savings account can be a powerful tool for growing deposits. The key is to make it as simple as possible for customers to set up transfers. You can even offer automatic transfers each time a payroll check is deposited into a customer's checking account.
- **Banking alerts.** E-mail or text-message alerts that warn customers of low balances or NSF status can encourage them to deposit or transfer funds and avoid overdraft fees.
- **Bill paying.** Online bill paying provides a convenient way for customers to manage their finances as well as an incentive to keep more funds in the bank.
- **Financial planning tools.** Financial calculators, budgeting programs and other planning tools can help customers manage spending and encourage them to save.

The key to all of these tools, of course, is convenience. The easier you make it to do business with your bank, the more likely you are to attract new business. But remember, when you make it easier for legitimate customers to do business with you, you also make it easier for fraudsters, identity thieves, money launderers and other criminals.

Risks to guard against

If you're contemplating offering online banking or adding new features to your existing site, be sure to plan carefully and take steps to minimize security risks. According to a University of Michigan survey conducted last year, more than 75% of bank Web sites surveyed (including some of the country's largest banks) had at least one design flaw that made customers vulnerable to cybertheft.

Common flaws included:

- Placing secure login boxes on insecure pages,
- Placing contact information and security advice on insecure pages,
- Redirecting customers to third-party sites without warning,
- Allowing inadequate user IDs and passwords, and
- E-mailing security-sensitive information insecurely.

Most of these problems are easily solved by using the secure socket layer (SSL) protocol on pages that ask for sensitive information and making other relatively simple changes to your bank's Web site.

If you offer online account opening, it's critical to ensure that your customer identification procedures comply with BSA/AML requirements. Many banks have opted not to allow online account opening because of risk of noncompliance. Others permit customers to begin the process online but still require them to visit a branch or send in documents by mail to complete the transaction.

With the advent of digital signatures and other technologies for authenticating a customer's identity online, online account opening is becoming safer and more prevalent.

Handle with care

In today's competitive environment, banks need any edge they can get in the battle for customers. The convenience of online banking can provide a competitive advantage, but it's important to take your time and be sure that you have the appropriate procedures, internal controls and security measures in place. Just one incident of fraud or identity theft can do irreparable damage to your bank's reputation. ▲

Avoiding "capital" punishment

Maintain adequate capital in today's economy

The current financial crisis has most banks focusing on liquidity issues and credit risk. But neither can you afford to neglect capital adequacy. Not only is capital essential to a safe and sound financial institution, but without adequate capital it's difficult for banks to make new loans and engage in other activities that drive future growth.

> There are two basic approaches banks can use to address capital deficiencies. One is to raise new capital. The other is to eliminate risk.

Liquidity risk may be the most immediate threat, but a bank's long-term survival depends on having enough capital to provide a cushion against unanticipated losses and future market volatility. Recent events have weakened many banks' capital positions and created the need for strategies to deal with the problem.

How banks got into trouble

Banks are required to maintain levels of capital that are commensurate with their risk profiles. In other words, the greater the risk of losses associated with a bank's activities and investments, the greater amount of capital it needs to absorb those potential losses.

In most cases, banks whose capital is dangerously low got into trouble not because they lost capital, but because their risk levels suddenly increased. Virtually everyone underestimated the risk associated with certain assets; when the value of those assets plummeted, the capital buffer many banks thought they had disappeared.

Consider the Federal Home Loan Bank (FHLB) of Seattle. Earlier this year, the bank announced that it no longer met regulatory capital requirements. Although the bank's capital-to-assets and leverage ratios were in compliance in December 2008, by the end of February 2009 it was suffering a risk-based capital deficiency, primarily caused by the declining value of certain mortgage-backed securities. In one year, the Seattle FHLB plunged from a $19 million profit to a $240 million loss.

Capital ideas

There are two basic approaches banks can use to address capital deficiencies. One is to raise new capital. The other is to eliminate risk to reduce their capital needs.

Raising capital. There are several ways to raise new capital, including:

- Tapping existing investors for an injection of capital;
- Seeking new investors — for larger community banks, private equity funds may be an option, and many of these funds still view banking as a good investment opportunity; and
- Borrowing at the holding company level and using the proceeds to inject capital into subsidiary banks.

Your risk assessment should consider six major risk areas: credit, market, operational, liquidity, legal and reputational.

One variation on the "borrowing at the holding company" strategy involves issuing trust-preferred securities (TPS). Bank holding companies can issue these securities, which possess characteristics of both equity and debt, and use the proceeds to provide capital for their subsidiary banks. TPS is an expensive way to raise capital, however, especially today. Opportunities to reduce costs by participating in pooled TPS funds have all but dried up, although some bankers' banks continue to offer TPS programs to their members.

Eliminating risk. These days, raising new capital can be a challenge. Many investors are justifiably circumspect, particularly when it comes to financial institutions. It may be more effective to look at strategies for reducing the need for capital. Here are a few possibilities:

- Sell off troubled assets (easier said than done in the current economic environment).
- Eliminate risky concentrations of business in certain geographical areas, borrowers or loan types.
- Form a "bad bank." Some banks are employing this strategy, which involves forming a holding company subsidiary to hold the bank's most troubled assets for sale at a more desirable time. Meanwhile, the "good" bank's capital levels are improved, enabling it to start lending again. Not surprisingly, this technique presents a number of legal and regulatory obstacles.

Before you can identify capital planning strategies, you must evaluate your capital needs, and to do that you need to conduct a risk assessment. By understanding your risks, you can determine how much capital is required and, if appropriate, develop strategies for reducing your risks.

Assess risk in context

Your risk assessment should consider the six major risk areas outlined by the Federal Reserve's banking risk framework: credit, market, operational, liquidity, legal and reputational. You should evaluate these factors in the context of your current and planned business lines, products and services, banking functions and activities, and legal structure.

Regulators are also placing greater emphasis on stress testing and sensitivity analysis, which can help you predict the impact of potential economic changes on your bank's financial condition.

Explore your options

This article lists several potential strategies for improving your bank's capital position. The right strategies for your bank will depend on your particular circumstances. One thing is certain, though: Inaction is not an option. The banks that survive and thrive in the coming years will be those with a solid strategic plan that addresses their current and future capital needs. ▲

Dealing with troubled loans

For the first time in years, banks face significant numbers of troubled loans, so it's important to be diligent in identifying, monitoring and, if appropriate, restructuring them.

Reworking a problem loan can be a viable alternative to foreclosure. Not only does it allow you to avoid the cost and stress of foreclosure proceedings, but in many cases it enables you to recover more of the loan principal than you would through a foreclosure sale. It also may help you retain a potentially profitable banking relationship.

As you review your loan portfolio and make decisions about how to handle troubled borrowers, it's a good idea to familiarize yourself with the accounting issues surrounding "troubled debt restructurings" (TDRs).

Develop an early warning system

The earlier you identify potentially troubled loans, the better your chances of minimizing your losses, whether by restructuring the loans or foreclosing. You should have systems in place to spot and monitor signs of increased credit risk in your portfolio, such as high concentrations of loans in particular geographical areas or loan types.

Other warning signs of credit risk include transactions with high loan-to-value ratios and borrowers with elevated debt-to-income ratios or large unsecured debt limits.

You also should look for signs that borrowers are experiencing financial difficulties, such as defaulting on one or more debts or lacking sufficient cash flow to service their debts.

The decision whether to restructure a loan or foreclose depends on your assessment of the borrower's ability to repay the loan (as modified), the amount you could recover through foreclosure and the continued value of the banking relationship. A credit analysis can help you evaluate these factors and, as discussed below, can help you determine whether a modified loan would be considered a TDR for accounting purposes.

Know the difference between TDRs and other restructurings

Before you restructure a loan, it's important to understand how it will affect your financial statements. The key issue is whether a restructuring constitutes a TDR. The criteria are found in FASB's Statement of Financial Accounting Standards (SFAS) No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

Under SFAS 15, a restructuring is a TDR if the bank "for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider." Determining whether a restructuring is a TDR involves a two-part test:

1. Is the borrower experiencing financial difficulty?

2. Has the bank granted a concession?

Generally, the following factors indicate that a borrower is experiencing financial difficulty:

- Default on any debts,
- Bankruptcy,
- De-listing of the borrower's securities,

- Doubt as to whether the borrower will continue as a going concern,
- Insufficient projected cash flows to service the loan, or
- Inability to obtain funds from other sources at market rates for similar loans to nontroubled borrowers.

Concessions include assets transferred or equity interests granted in full or partial satisfaction of the loan (unless their fair value is equal to the loan's book value). But the most common type of concession is a modification of loan terms.

Loan modifications might include reducing the interest rate, the principal or accrued interest; extending the maturity date at a below-market interest rate; adding contingent payment provisions (based on meeting profitability goals, for example); or substituting or adding a new borrower or guarantor.

But remember that not every loan modification is a TDR. A bank that renews or extends a loan at the same or a lower interest rate does not trigger TDR accounting if the rate is equal to the market rate for a new loan with similar risk. A lower rate may reflect declining market rates or the borrower's increased creditworthiness, for example, rather than a troubled loan situation.

Understand the accounting implications

If a loan modification constitutes a TDR, it must be evaluated for impairment in accordance with SFAS 114, *Accounting by Creditors for Impairment of a Loan*. Generally, the amount of impairment is based on the difference between the loan balance and the present value of the loan's expected future cash flows (discounted at the loan's *original* interest rate). In some cases, however, impairment may be based on the loan's observable market price or, if the loan is "collateral-dependent," on the collateral's fair value (less selling costs).

If the resulting amount is less than the loan's book value, the difference is the amount of impairment, which should be recognized as a valuation allowance or, if the impairment is determined to be uncollectible, as a loss. (See "An example of a troubled debt restructuring (TDR)," above right.)

Special rules apply when the bank receives equity or assets. But, in general, if equity or assets are accepted in full satisfaction of a loan, impairment is based on their fair value (less selling costs in the case of certain long-lived assets).

An example of a troubled debt restructuring (TDR)

John is unable to make the payments on a $300,000 loan from his bank. The loan is secured and bears interest at 5%, which also is the current market rate. The bank agrees to restructure the loan, with interest-only payments of 3% for two years and a final payment of $309,000 (the principal plus 3% interest) at the end of year three.

Assuming that the loan is neither collateral-dependent nor readily marketable, impairment is measured by the present value of expected future cash flows, discounted at the loan's original interest rate. In this case, the present value of John's expected payments under the restructured terms, discounted at 5%, is $283,661.

The impairment — that is, the difference between the loan's recorded value ($300,000) and the present value of the payments ($283,661) — is recognized through a $16,339 valuation allowance.

Perform a credit analysis

Whenever you restructure, renew or extend a loan under modified terms, it's important to conduct a thorough credit analysis. As explained above, a loan modification is not considered a TDR if the new terms are consistent with market rates for new loans with similar risks.

A credit analysis evaluates the risk associated with a restructured loan and helps support the bank's classification of the restructuring as a TDR or a non-TDR.

Looking for trouble

This article touches on just a few of the accounting issues involved with restructured loans. Other issues include the accrual or nonaccrual status of TDRs, treatment of TDRs on call reports and the accounting treatment of loan modifications that are not TDRs.

In today's struggling economy, banks need to be proactive in looking for signs of troubled loans and taking appropriate steps to minimize their losses. If a bank determines that restructuring a loan is the best course, it's important to understand and apply the relevant accounting standards. ▲

Are your business customers looking to switch banks?

A recent survey by research firm Greenwich Associates revealed that nearly half of small and middle-market companies in the U.S. are "actively seeking a new bank or would consider changing banks if presented with a compelling offer."

Greenwich surveyed 670 companies, consisting of 260 small businesses and 410 middle-market companies. As of the end of 2008, almost half of small businesses and 40% of middle-market companies were looking for a new bank or were open to the idea. In contrast, at the beginning of 2007, less than one-third of companies participating in the survey were looking to switch.

This trend represents a threat to community banks. But it also presents an opportunity for banks to increase their market share by fixing the things that dissatisfy customers.

Why are they unhappy?

According to Greenwich, the main reasons companies want to switch banks are "lack of demonstrated commitment to the business," "poor communication" and "uncertainty regarding financial health." This is a departure from previous years, when price and service issues were the primary reasons for customer dissatisfaction (although they remain a factor for many of the survey respondents).

In addition, many companies are concerned about reductions in credit availability and changes in credit terms brought on by the current economic climate. Many loyal, long-term, creditworthy customers felt that they had been mistreated by banks that subjected them to the same tough restrictions — reduced credit, stricter terms and higher fees — as everyone else.

What should you do about it?

Although customer dissatisfaction is a serious threat to banks that ignore the problem, it presents banks with an opportunity to retain existing customers and attract new ones by making an effort to improve communications and provide more personalized attention.

Around 25% of survey respondents that switched banks in the preceding year said that their previous banks could have kept their business with better communication and responsiveness or simply by "appreciating our business and treating us better."

In light of the various reasons customers give for their dissatisfaction, many banks should be able to reverse the trend and hold onto customers by improving communications, making credit decisions on a case-by-case basis, showing more appreciation for long-term customers and providing greater transparency regarding their own financial condition.

Back to basics

The lesson here seems to be that now, more than ever, community banks need to focus on the things that historically have distinguished them from their larger competitors: pluses like personalized service, access to senior management, and credit decisions based on customers' individual circumstances rather than application of a formula.

By refocusing on these areas, community banks can help preserve existing customer relationships and attract new ones. ▲

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