P&G Banking ADVISOR

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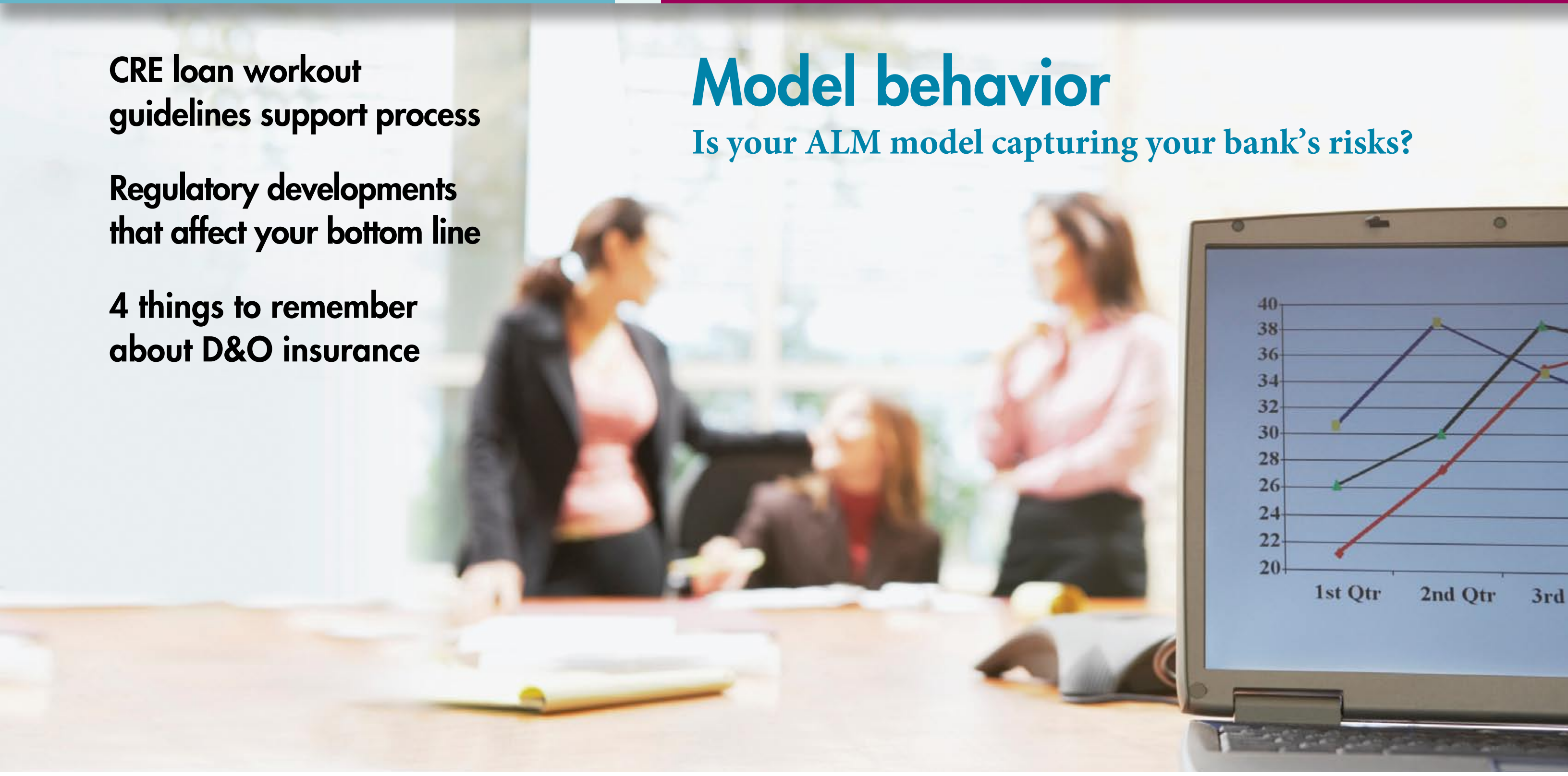

CRE loan workout guidelines support process

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Model behavior

Is your ALM model capturing your bank's risks?

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Model behavior

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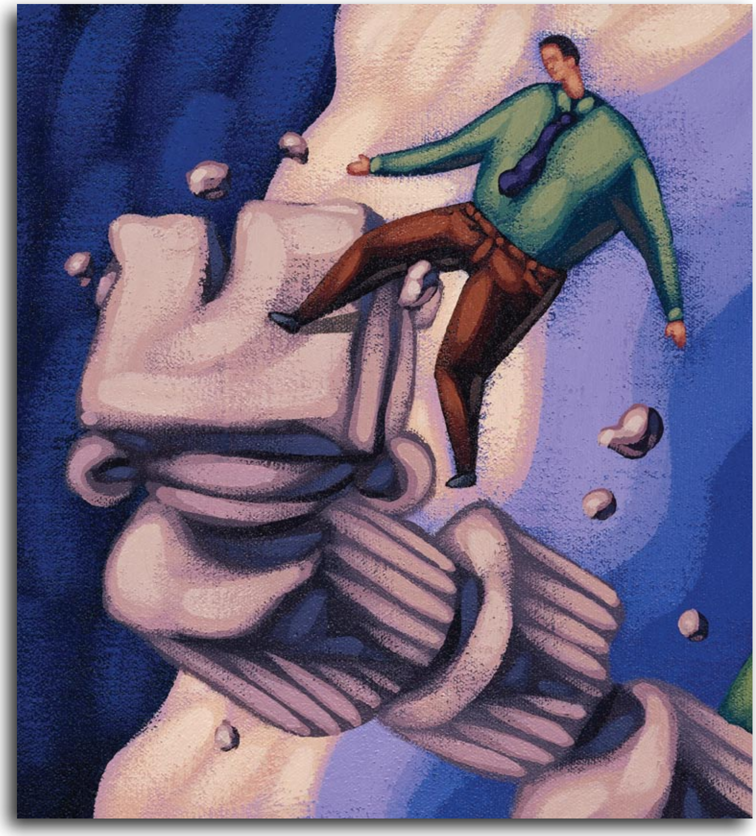
Asset-liability management (ALM) is a critical activity for banks — not just for meeting regulators' expectations, but also as a strategic tool for controlling risk and enhancing performance. In today's high-risk environment, it's critical for a bank's board of directors or asset and liability committee to take a proactive approach to ALM.

There are a variety of ALM modeling software programs available, ranging from simple spreadsheets to outsourced solutions and sophisticated, highly customized in-house systems. Here are some questions to ask as you evaluate your bank's program.



What's your bank's risk profile?

The right ALM system for your bank depends on the complexity of your balance sheet and the degree of risk to which it's exposed. Nearly every balance sheet includes some level of complex financial products and instruments where simulation modeling is needed. These products and instruments typically contain embedded options — such as prepayment rights for loans or securities and early withdrawal options on deposits.

The level of sophistication your bank requires in a simulation model depends on its risk profile.

There might also be put or call provisions, caps and floors, or conversion rights on investments or alternative funding sources. Evaluating the risks these options present requires detailed assumptions about future interest rates, economic conditions and customer and investor behavior.

Is your model dynamic?

Static simulation models are simpler but of limited value because they assume a constant balance sheet without new growth. More sophisticated dynamic models incorporate assumptions about potential new business and changes in business lines. Again, the level of sophistication your bank requires depends on its risk profile.

A model is only as good as its assumptions. A dynamic model will include assumptions about the behavior of your bank's current business as well as assumptions about future business. Where does this data come from? Some models incorporate actual details about your portfolio, while others rely on aggregate data. Actual details should be imported directly into the program to avoid errors.

What about liquidity risk?

Traditionally, ALM models have focused on interest rate risk, but in recent years liquidity risk has emerged as a significant financial risk. Much of the data captured by ALM models can be useful in managing liquidity risk, but few banks take full advantage of these capabilities. Check to see if your ALM software can measure liquidity risk or export the necessary data to a liquidity modeling program.

Managing risk

ALM modeling allows you to measure your bank's risks and to take action — such as reducing your exposure or increasing your capital — if those risks are unacceptably high. The type of model and level of sophistication that's right for your bank depends on its size, complexity, business model, risk profile and other characteristics. ▲

CRE loan workout guidelines support process

Community banks with high concentrations of commercial real estate (CRE) loans face a dilemma: Even though it may be in the best interest of both bank and borrower to modify or restructure a troubled CRE loan, workouts may also create a risk that the loan will be adversely classified by bank examiners, which can have a negative impact on the bank's earnings, liquidity and capital.

Understanding federal guidance

Guidance issued last October from the federal banking agencies can help your bank resolve the CRE loan dilemma. The agencies' joint *Policy Statement on Prudent Commercial Real Estate Loan Workouts* recognizes that loan workouts sometimes result in adverse classifications. But the statement provides assurance that your bank won't be criticized for engaging in workout arrangements that follow statement guidelines. The statement also provides that a restructured CRE loan won't be adversely classified *solely* because the value of the real estate has declined or because the borrower is in a distressed industry. This allows you to rework CRE loans to accommodate creditworthy borrowers without hurting your bank's bottom line.

Reviewing borrower finances

To ensure your bank meets regulatory standards for CRE loan workouts, you should:

- Develop a prudent workout policy that sets appropriate loan terms and amortization schedules.
- Create individualized workout plans that analyze a borrower's or guarantor's current financial information and support loan repayment.
- Analyze the borrower's global debt service capacity.
- Implement a system for monitoring ongoing performance.

- Have an internal loan grading system that reflects the risk associated with workout arrangements.
- Use an allowance for loan and lease losses methodology that recognizes credit losses.

The policy statement provides detailed guidance on analyzing a borrower's repayment capacity, evaluating guarantees and assessing collateral values. The guidance not only helps your bank meet regulators' expectations for loan workouts, but it's also a valuable tool for evaluating risks case-by-case.

Classifying loans

Regulators generally classify loans in one of five categories:

1. Pass — The loan is performing, with no potential weaknesses that would jeopardize repayment.
2. Special mention — Potential weaknesses, left uncorrected, could hurt the borrower's repayment prospects.
3. Substandard — The loan is inadequately protected by the borrower's repayment capacity and collateral values.
4. Doubtful — Weaknesses make full repayment highly questionable and improbable.
5. Loss — The loan is uncollectible or of little value.

Depending on the severity of any recognized weaknesses, an adversely classified loan may require the bank to increase its reserves, place the loan on nonaccrual status or even recognize a loss. (See "Troubled debt workouts" below.)

Addressing sound borrowers

Naturally, banks are reluctant to approve loan workouts when doing so would have a negative impact on their financial statements. The policy statement provides banks with greater flexibility to rework loans to borrowers that are essentially sound without taking a financial hit.

One area where the new policy will be particularly valuable is extensions of maturing loans. Consider a loan made to finance a CRE construction project. If the value of the collateral has deteriorated, the borrower may have trouble obtaining long-term financing, even though it has the ability to continue servicing the debt. A reasonable extension of the maturity date won't result in adverse classification absent some distinct weakness that jeopardizes repayment.

The statement also identifies the benefits of splitting a distressed loan into two separate loans: a "good" loan, for which the borrower has demonstrated a capacity

Troubled debt workouts

According to the banking regulators' joint policy statement (see main article), modified CRE loans should be evaluated to determine whether they should be placed on nonaccrual status, whether they require adjustments to the bank's reserves and whether they should be reported as a "troubled debt restructuring" (TDR).

Under Generally Accepted Accounting Principles, a workout is a TDR if the bank, for economic or legal reasons related to the borrower's financial difficulties, grants a concession it wouldn't otherwise consider. To determine whether a workout is a TDR, you must assess: 1) whether the borrower is experiencing financial difficulties, *and* 2) whether you've granted a concession.

Factors reflecting financial difficulties may include default on debts, bankruptcy and inadequate projected cash flow. Concessions may include renewing a loan at a below-market interest rate or adding contingent payment provisions. Loans reported as TDRs must be evaluated for impairment, which can cause the bank to recognize a loss.

to repay, and a "bad" loan, which is adversely classified and charged off as appropriate. Under the right circumstances, the good loan may be classified "pass" and remain on (or be returned to) accrual status. This strategy allows the bank to maintain at least a portion of the loan as a performing asset.

Developing a workout regimen

You should review your loan portfolio and set policies for dealing with distressed CRE loans. By following the policy statement's guidelines, you can develop prudent workout strategies that will minimize the financial impact on your bank. ▲

Regulatory developments that affect your bottom line

Banks are governed by a wide array of regulatory bodies, including the federal banking agencies, the IRS, the SEC and various state agencies. These regulators can have a significant impact — both positive and negative — on your bank's bottom line, so it's important to monitor their activities. Here are a few suggestions based on recent regulatory developments.

Review securities activities

Regulation R, which was issued jointly by the SEC and the Federal Reserve, defines the extent to which a bank's securities activities are subject to SEC oversight. If your bank's activities go beyond those permitted by Regulation R, you must either register as a broker with the SEC or "push out" these activities to a registered broker. Failure to comply can result in hefty fines as well as potential criminal penalties.

As you review your bank's securities activities for compliance with Regulation R, consider whether it would be advantageous to expand these activities and register as a broker with the SEC. For some banks, the cost of registration will be more than justified by the additional fee income it will generate.

Most banks are involved with securities transactions to some extent. The goal of Regulation R is to strike a balance between a bank's need to accommodate its customers and the SEC's interest in protecting consumers.

Unless your bank falls within one of the regulation's narrowly defined exceptions, it may be subject to the SEC's broker-dealer registration requirements.

Key exceptions relate to third-party networking arrangements, trust and fiduciary activities, deposit "sweep" activities, and custody and safekeeping activities. For example, the second exception permits banks to effect securities transactions for trust and fiduciary customers provided their compensation is limited to certain types of fees, such as an annual fee or a percentage of assets under management. The sweep account exception permits banks to sweep funds into qualifying "no-load" money market funds.

Look into enterprise zones

Many states offer tax incentives for banks that loan money to businesses in economically distressed "enterprise zones." Some states allow lenders to take a "net interest deduction" — in other words, net interest income on qualifying loans is tax free. Others offer tax credits equal to a percentage of a bank's interest income from enterprise-zone loans.

Recently, California's Franchise Tax Board announced that it was expanding its net interest deduction to include loans made to not-for-profit organizations operating in enterprise zones. The board recognized nonprofits as being "engaged in a trade or business" for purposes of the deduction.

If you haven't already done so, it pays to research enterprise-zone benefits and similar tax breaks in the states where your bank does business.

Watch for FDIC premium deductions

FDIC-insured financial institutions were required to prepay more than three years' worth of estimated quarterly risk-based assessments by Dec. 30, 2009. The prepayment covered the fourth quarter of 2009 up to and including the fourth quarter of 2012. Many banks hoped that this additional financial burden would be eased somewhat by an accelerated income tax deduction. But the IRS has announced that it won't permit such a deduction.

Should a court rule against the IRS on the prepayment issue, banks might be entitled to amend their returns and claim an accelerated deduction.

Generally, prepaid expenses are capitalized and deducted over the period during which the benefits are received. There's an exception, however, for prepaid

expenses whose benefits don't extend beyond the earlier of 12 months after the benefits begin or the end of the following taxable year. Banking groups argued that, because the FDIC's invoices clearly separated prepayments attributable to 2010, the "12-month rule" permits banks to deduct these amounts on their 2009 returns.

In an oral conversation with the American Bankers Association, an IRS representative said that the agency will treat the prepayments as a single lump sum that relates to the entire 13-quarter period, so the 12-month rule won't apply. Still, banks should monitor developments in this area. Should a court rule against the IRS on this issue, banks might be entitled to amend their returns and claim an accelerated deduction.

Explore opportunities, face challenges

It's tempting to view banking and tax regulations as nothing more than a compliance headache. But paying close attention to regulatory developments can also reveal opportunities to boost — or situations that shrink — your bottom line. ▲

4 things to remember about D&O insurance

Last year's so-called bailout of some of the nation's largest banks created an excess of taxpayer ill will. To avoid similar misgivings among your customers, now's an optimal time to review your directors & officers (D&O) liability protection. Here are four points to keep in mind:

1. A typical policy contains three parts. The first part protects individual directors and officers against personal liability to the extent they're not indemnified by the bank. That may happen if the bank is legally prohibited from indemnifying them (for instance, in a derivative action) or is financially unable to do so. The second part reimburses the bank for indemnification payments made to directors and officers. And the third covers the bank for its own liabilities in connection with claims against directors and officers.

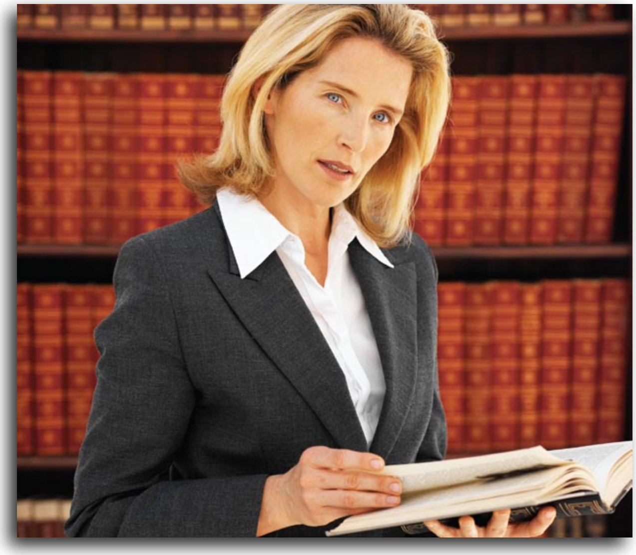
2. Broad coverage is desirable. Lawsuits against directors and officers almost always name the bank, too. Most new D&O policies — but not all of them — include entity coverage. But even if your policy includes this coverage, recoveries could be limited. "Named-peril" policies cover only specific types of exposure. "Bankers professional liability" policies, for example, may limit entity coverage to claims involving specific fee-based services. And some policies are limited to claims brought by certain individuals, such as customers. That means coverage would be excluded for claims by regulators, employees, shareholders and other third parties. If possible, negotiate a policy with "broad form company liability" coverage.

3. Limits should reflect your bank's needs. Policy limits should be in line with your bank's structure, activities, risk profile and risk tolerance. Bear in mind that, unlike a typical general liability policy, a D&O policy's limits include defense costs. For example, if your policy has a $5 million aggregate limit and you incur $5 million in attorneys' fees and court costs defending a claim, there will be nothing left to satisfy a judgment or settlement.

You'll also want your policy to *advance* defense costs. Even if the policy will ultimately reimburse these costs, requiring individual directors and officers to cover them as they're billed can be an enormous hardship. Sometimes claims against the bank can "erode" the limits available for individual directors and officers. Consider buying a separate "A-side" policy or negotiating nonerosion language to ensure that claims against your bank won't deprive individual directors and officers of personal-liability protection.

Also, look for "order of payments" language providing that claims against individual directors and officers will be paid before claims against the bank. This provides an extra layer of protection for directors and officers, and can help prevent D&O proceeds from being treated as bank assets if bankruptcy should occur.

4. Your application should be accurate. Most D&O policies allow the insurance company to rescind the policy in the event of any "material misstatements or omissions" in the application. Although the rescission is generally limited to directors and officers who knew about misstatements or omissions at the time the application was filed, this knowledge can be imputed to others. In other words, the insurer can cancel coverage even for directors and officers who weren't involved in the application process and were unaware of any alleged misrepresentations. ▲



P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

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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.

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