

P&G Banking

A D V I S O R

Spring 2011

**Do you think all
financial statements
are created equal?**

ALL best practices
**Pay attention to
qualitative factors**

BANK Wire

**4 tips for boosting
noninterest income**



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4 tips for boosting noninterest income

Noninterest income is critical to a bank's long-term success. This is particularly true today, when a variety of economic and regulatory factors are having a negative impact on net interest income.

At the same time, noninterest income is declining for many banks. There are numerous reasons for this, including general economic conditions and regulatory changes, such as opt-in requirements for overdraft protection fees and limitations on credit card fees and debit card interchange fees.

Revenue-generating strategies

Common sources of noninterest income include deposit account service charges, loan origination and servicing fees, overdraft and NSF charges, and gains on

sales of loans and investment securities. Noninterest income also may be derived from various products and services, including insurance and annuity products and brokerage, trust and financial planning services.

High waiver rates — some estimates are higher than 50% — can quickly wipe out substantial amounts of revenue.

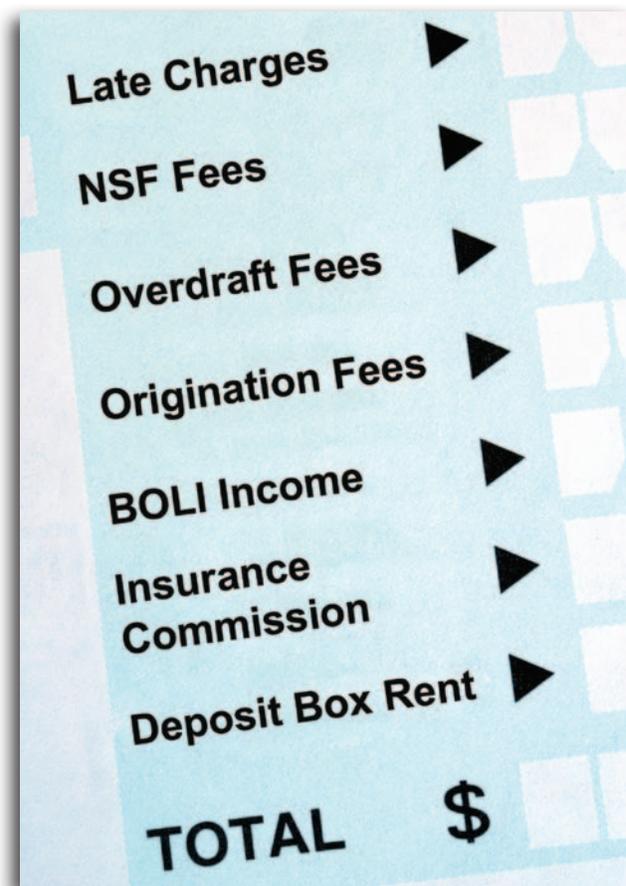
Here are four strategies for increasing noninterest income:

1. Improve collection of current fees. Banks are notoriously easy on customers, waiving NSF fees and other penalties anytime they receive a complaint. Although it's important for bank personnel to have the discretion to waive these fees, high waiver rates — some estimates are higher than 50% — can quickly wipe out substantial amounts of revenue.

To keep waivers under control, set a target level for discretionary waivers and train bank personnel so they can understand the significance of noninterest income, make good decisions regarding fee waivers and handle customer complaints. Try automating the fee initiation process so that nothing falls through the cracks and incorporate waiver targets into your incentive compensation decisions.

Finally, be sure to include fee waiver data in regular management reports so you can monitor results.

2. Get to know the competition. Banks often miss opportunities to charge higher fees because they fail to keep tabs on their competitors. Identify the predominant banks in your market and procure their fee schedules. Comparing competitors' fees to your own may uncover significant pricing opportunities.



That doesn't mean you should increase your fees to match the highest priced banks in your area. But if you find your fee schedule is on the low end of the spectrum, a modest increase can have a significant impact on your bank's revenue.

If you do increase your fees, monitor your results closely to ensure the strategy produces the desired outcome. And, as noted above, consider automating the fee initiation process.

3. Put a value on banking relationships. Relationship value pricing can be a highly effective strategy for enhancing fee revenue. It sets prices based on the overall value of a banking relationship with a customer or group of customers (such as a family or a business and its employees).

In its simplest form, relationship value pricing might involve package deals for products or services. A common example is free checking accounts for customers who maintain a minimum loan balance. A more sophisticated approach is to develop customized pricing based on a valuation of the products and services a specific customer receives.

For relationship value pricing to work, it's important that your bank carefully analyze the costs and benefits associated with the customer relationship to ensure the relationship is sufficiently profitable. Also, it's critical to have systems that monitor the relationship. Banks often lose revenue because they're unaware that the relationship has changed. For example, a bank might continue providing free checking even though the related loan has fallen below the minimum balance or has been paid off.

4. Buy life insurance. Buying insurance policies on the lives of directors, officers and other key employees can be a cost-effective tool for boosting noninterest income. Your bank can purchase insurance itself or use "split-dollar" arrangements to share the costs and

Keeping BOLI off your tax bill

The Pension Protection Act of 2006 (PPA) placed restrictions on the use of bank-owned life insurance (BOLI) and other "business owned" or "corporate owned" life insurance. Congress was concerned about abuses by companies that secretly insured the lives of rank-and-file employees in whom they had little or no insurable interest, often collecting tax-free death benefits years or even decades after the employees had left the company.

To discourage these abuses, the PPA provided that tax-advantaged BOLI benefits are available only if:

1. The insured individual was employed by the bank during the 12 months before his or her death or was a director or "highly compensated" individual when the policy was issued; or
2. The proceeds are paid to an insured employee's heirs or used to acquire an equity interest in the bank from those heirs.

Even if an employee falls within one of the above categories, tax-free benefits are available only if the bank notifies the employee in writing of its plans and obtains the employee's written consent *before* the policy is issued.

benefits of these policies with employees. Bank-owned life insurance (BOLI) is often used to fund supplemental executive retirement plans, other nonqualified deferred compensation plans and retiree health benefits.

BOLI can be a powerful planning tool because a life insurance policy's cash value grows on a tax-deferred basis and, if the policy is held until the insured employee dies, the death benefit is generally tax-free. A caveat: To enjoy these tax benefits, your bank must comply with strict notice and consent requirements before purchasing a policy on an employee's life. (See "Keeping BOLI off your tax bill" above.)

Your strategic plan

In addition to the four ideas described above, make sure you review your strategic plans and consider new strategies for generating noninterest income. These might include offering new products and services, expanding into new markets, or entering new business lines, such as brokerage services, insurance sales or financial planning. ▲

Do you think all financial statements are created equal?

When you sit down to review a customer's financial statements, do you basically proceed in the same way from borrower to borrower, looking for signs of financial strength in the business and its industry? That's par for the course. But don't forget to consider the differences between public and private companies, the customer's incorporation type, and the accounting method used.

How is the company held?

Companies that trade stock on the NYSE or other public market have one primary concern when preparing financial statements: maximizing earnings per share. Public companies also tend to be large conglomerates that dabble in several industries.

Conversely, privately held firms often view earnings differently. Many strive to *minimize* earnings for tax purposes — for example, through aggressive downward inventory valuations and running personal travel and entertainment expenses through the company.

Moreover, public company financial statements tend to be more reliable, because they're under the scrutiny of

the SEC, market analysts and investors. If you're lucky, closely held companies will submit audited or reviewed financial statements. More likely, private firms will rely on internal reports or tax returns.

What's the borrower's corporate structure?

C corporations are taxed twice: First, income is taxed at the corporate level; then shareholders pay personal taxes on dividends. Companies often elect S status to avoid double taxation on corporate earnings. S corporation earnings flow through to the owners' personal tax returns and individual owners pay tax on those earnings.

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S corporations may appear more profitable, because there are no federal or state income tax provisions. But S corporations often pay large annual distributions to help shareholders cover their tax obligations.

Another key difference is how these entities pay shareholder-managers. C corporations can lower taxable income (and avoid double taxation on dividend payments) by maximizing owners' compensation. S corporations can avoid payroll taxes if they substitute distributions for compensation expense. S corporation borrowers who attempt to underpay shareholder-managers could face IRS scrutiny, however.



Which accounting methods are used?

Small borrowers may use cash-basis accounting methods, which report revenue when customers pay invoices and the company pays its expenses. Conversely, accrual accounting methods match revenue (and expenses) to the periods in which they're earned (or incurred).

Cash-basis entities tend to report large fluctuations in profits from period to period, especially if they're engaged in long-term projects. Several asset and liability accounts also are absent on a cash-basis balance sheet, such as prepaid expenses, accounts receivable, accounts payable, work in progress, accrued expenses, deferred taxes, and costs in excess of billings or billings in excess of costs.

Discretionary accounting methods also can affect financial reporting. For example, small borrowers have discretion over which methods of depreciation they use and how they account for the lives of fixed assets. So if their financial statements use IRS accelerated depreciation or Section 179 elections, net income would be lower in the earlier years of an asset's useful life, in contrast with a less aggressive methodology that extends depreciable life and thus defers the expense over a longer period.

Another accounting difference involves bad debts. Policies vary on how management writes off uncollectible



accounts and estimates bad debts. Borrowers that don't book an allowance for bad debts or review receivables aging may be overstating their assets and profits.

Other variations and measurement

Businesses also can be discretionary in their accounting treatment for real estate. Companies that own their facilities look different on paper from those that rent. Property owners will report higher fixed assets and depreciation expense in lieu of rent expense.

Your CPA can help you pinpoint accounting treatment implications and develop benchmarking measurements that will take into account your borrowers' differences. And that will help you more accurately predict their potential performance. ▲

ALL best practices

Pay attention to qualitative factors

Staying on top of the allowance for loan and lease losses (ALLL) is critical for banks, especially in the current economy. If examiners find that your ALLL is underfunded, they may downgrade your bank's CAMEL rating, require you to increase capital levels or take other remedial action.

One of the biggest challenges in calculating the ALLL is assessing the impact of qualitative, or "environmental," factors. These are factors that cause your bank's loss estimates to deviate from its historical loss experience. Interagency guidance provides a useful outline for this analysis, but will examiners expect you to go further?



Agencies issue guidance

Federal banking agencies published their Interagency Policy Statement on the ALLL in 2006. According to the policy statement, the *starting point* in measuring the ALLL is to “determine the historical loss rate for each group of loans with similar risk characteristics in its portfolio.” Next, management should consider qualitative factors likely to cause the bank’s estimated credit losses to differ from historical losses. These factors include changes in:

- Lending policies and procedures,
- Business conditions (on an international, national, regional or local level),
- Loan volume, terms or profiles,
- The lending staff’s experience, ability or depth,
- The volume or severity of problem loans,
- Loan review quality,
- Collateral values, and
- Credit concentration levels.

Banks also should consider other external factors, including competition and legal and regulatory requirements.

Examiners suggest best practices

In a recent *SRC Insights* article, “Qualitative Factors and the Allowance for Loan and Lease Losses in Community

Banks,” authors Sharon Wells and Trevor Gaskins, examiners with the Federal Reserve Bank of Philadelphia, reported observing a number of weaknesses in banks’ ALLL methodologies. One of the biggest problems they saw was inadequate portfolio segmentation.

The interagency policy statement instructs banks to group loans with similar risk characteristics, but many banks segment their loan portfolios into overly broad categories, which may not accurately reflect underlying risk factors. Depending on a bank’s size, and the nature and scope of its lending activities, it may be appropriate to segment the loan portfolio into narrower categories.

Another area where banks fall short is the examination of qualitative factors. Too often, banks limit their analysis to the broad factors outlined in the policy statement. According to the authors, however, a best practice is to “prepare an institution-specific and customized risk assessment of each portfolio sector based upon the unique characteristics and loss drivers of that loan portfolio.” The article contains a detailed list of loss drivers that banks should consider in conducting their analyses.

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Finally, the article warns banks that their valuation of qualitative factors affecting the ALLL must be supported, documented and not overly dependent on subjective opinion.

Review your ALLL methodology

To ensure that your bank’s ALLL is adequately funded, review your methodology in light of the guidance described above. Your advisors can help you design ALLL policies and procedures that accurately reflect your bank’s unique risk profile. ▲



FASB BACKS OFF FAIR VALUE PROPOSAL

FASB is backpedaling on last year's fair value proposal. Under the proposal, most financial instruments, including bank loans, would be reported at fair value. Now, FASB has tentatively decided to allow banks to continue reporting loans held for collection at amortized cost.

Banks and banking organizations had criticized the proposal because it would subject loans held for collection to market volatility, even though cash flows from those loans come from customers. Under the revised proposal, only loans held for sale would be reported at fair value. ▲

ARE YOUR APPRAISAL PROGRAMS SOUND?

Banks should review their appraisal and evaluation policies and procedures and update them as needed in view of new guidelines issued by the five banking regulators in December.

The Interagency Appraisal and Evaluation Guidelines update guidance on sound practices for real estate appraisal and evaluation programs. The guidelines also clarify how banks need to comply with appraisal regulations due to changes in appraisal standards, advancements in collateral valuation methods and other recent developments. ▲

TDR DISCLOSURES DELAYED

FASB has deferred the effective date for certain disclosures about troubled debt restructurings (TDRs). Last year, it issued Accounting Standards Update (ASU) 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. The ASU requires entities to disclose "the nature and extent of troubled debt restructurings . . . and their effect on the allowance for credit losses."

The new requirements were scheduled to apply for periods ending on or after Dec. 15, 2010 (Dec. 15, 2011,

for nonpublic entities). So, calendar-year public companies would have to include the disclosures on their Dec. 31, 2010, financial statements.

Now, public entities can defer TDR disclosures until they adopt proposed guidance on determining what constitutes a TDR. The guidance is expected to apply to interim and annual periods ending on or after June 15, 2011. For nonpublic entities, the effective date for disclosures remains the first annual reporting period ending on or after Dec. 15, 2011. ▲



SAFE ACT REGISTRATION UNDERWAY

The Secure and Fair Enforcement for Mortgage Licensing Act imposes strict licensing and registration requirements on mortgage loan originators (MLOs). Among other things, MLOs employed by federally insured depository institutions (or by regulated subsidiaries that they own and control) must register with the Nationwide Mortgage Licensing System and Registry (NMLS), which began operation on Jan. 31, 2011. Covered MLOs must register by July 29, 2011. ▲



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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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.

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