P&G Banking ADVISOR

Spring 2012

Understand the tax implications of bank mergers

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BANK *Wire*

Suspicious activity: Are you seeing the big picture?

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Suspicious activity: Are you seeing the big picture?

Monitoring customer transactions for suspicious activity — and filing Suspicious Activity Reports (SARs) when appropriate — is a key component of a financial institution's Bank Secrecy Act / Anti-Money Laundering (BSA/AML) program. Unfortunately, many banks make the mistake of focusing their efforts on deposit accounts and paying less attention to other products and services, particularly lending.

Think of it this way: When you have a medical checkup, the doctors and nurses don't just take your temperature. They check a variety of vital signs — including blood pressure, heart rate and respiration — any one of which could signal a potential problem. Similarly, an effective BSA/AML program should look for suspicious activity by examining the *entire* customer relationship.

Assessing your risk

Federal regulators expect banks to take a risk-based approach to BSA/AML compliance. That means a bank's customer identification program, due diligence procedures and internal controls should be tailored to an individual bank's risk profile.

Once a bank conducts a risk assessment, it can design a BSA/AML compliance program that fits its risk profile.

Returning to our medical analogy, doctors don't routinely test patients for every possible disease. But specific symptoms or risk factors may warrant further investigation. Likewise, certain customers, products and services, and geographic locations present a higher risk

of money laundering or terrorist financing, demanding heightened due diligence.

These categories, by themselves, don't define the level of risk. But if particular customers or transactions fall into one of these high-risk categories, the bank should dig deeper to determine its actual risk.

Suppose, for example, that a bank's initial risk assessment shows that, each day, it processes 100 international funds transfers (a high-risk service). Upon further investigation, the bank discovers that 90 of these transfers are well-documented, recurring transfers for established customers, indicating a relatively low risk level. If, on the other hand, 90 of the 100 transfers are nonrecurring or for noncustomers, a very different risk picture emerges.

Once a bank conducts a risk assessment, it can design a BSA/AML compliance program that fits its risk profile. For example, a bank with many high-risk customers might establish more rigorous procedures for opening an account, thus requiring bank personnel to collect and verify additional information on customers or transactions perceived to be riskier.

Examining your lending activities

Most banks have strong controls for deposit accounts, but some are less diligent when it comes to the lending function. Part of the problem may be that the levels of due diligence required for credit risk purposes and for BSA/AML purposes don't necessarily coincide.

From a credit perspective, for example, loans secured by cash collateral or marketable securities are usually perceived to be relatively low-risk. But using cash or cash equivalents as collateral (and, in some cases, defaulting on the loan) is a common money-laundering technique. (See "Lending red flags" at right for a list of potentially suspicious lending activities.)

To minimize lending-related BSA/AML risks, banks should implement risk-based due diligence procedures. Procedures might include monitoring the use of proceeds to be sure they're consistent with a loan's purpose, ensuring that any cash investment or collateral is reasonable relative to the borrower's income, and verifying the source of funds when a loan is paid off early (particularly when the borrower is struggling financially).

In addition, banks should examine loan payments made by unrelated third parties or made in cash — particularly when the borrower isn't in a cash-intensive business. For high-risk loans, it's also a good idea to conduct due diligence on guarantors, principals and other related parties.

It's especially important to scrutinize cash collateral loans, given the high risk of money laundering. Verify the source of funds and be sure that the loan's purpose is reasonable in light of the borrower's business and background.

Finally, effective training is critical to ensure that loan department personnel can spot red flags, understand the procedures for evaluating and monitoring lending activities for BSA/AML purposes, and know the criteria for filing SARs.

Know your customers

To ensure your institution meets its BSA/AML obligations, suspicious activity monitoring should encompass the entire customer relationship and involve personnel throughout the institution, including lenders. Only then can you develop a complete picture of a customer's activities and identify trends or anomalies that suggest suspicious behavior. ▲

Lending red flags

In its BSA/AML Examination Manual, the Federal Financial Institutions Examination Council (FFIEC) describes several red flags that may raise bank suspicions:

- A borrower secures a loan by pledging assets held by an unrelated third party.
- A loan is secured by deposits or marketable securities.
- A borrower defaults on a loan secured by cash or other cash equivalents.
- A loan is made for, or paid on behalf of, a third party.
- A borrower secures a loan with a certificate of deposit (particularly when the CD is purchased with currency or multiple monetary instruments).
- A loan has no legitimate business purpose, provides the bank with significant fees for assuming little or no risk or obscures the movement of funds (for example, a loan that's made to a borrower and then immediately sold to an entity related to the borrower).

Any of these activities may serve legitimate business purposes, but it's incumbent on the bank to scrutinize them further to ensure there's a reasonable explanation.

Understand the tax implications of bank mergers

If your institution is contemplating a merger, there are a variety of tax issues to consider. Two key issues today are: the dividend vs. capital gain treatment of cash payments in a tax-free merger, and the preservation of deferred tax assets. It's also important to conduct thorough due diligence to uncover any tax liabilities you might inherit from the target bank.

Dividend vs. capital gain

Even in a "tax-free" merger, any portion of the purchase price paid in cash rather than stock (commonly referred to as "boot") is taxable to the acquired bank's shareholders. The question then becomes: Is boot taxed as a dividend or as capital gain? The answer is important for several reasons:

- Historically, capital gains have been taxed at a lower rate than dividends, although currently qualified dividends are taxed at the capital gains rate.
- If the target bank's stock is held by a C corporation, the C corporation will likely prefer dividend treatment. This allows it to take advantage of the dividends-received deduction (or, if the parties to the merger are part of a consolidated group, to treat the payment as a nontaxable intercompany dividend).
- In some cases dividend treatment may run afoul of regulatory dividend restrictions.

Determining whether boot is taxed as a dividend or capital gain can be complicated. The first step is to recharacterize the transaction as if the acquiring bank purchased the target bank's stock with its own stock and then immediately redeemed a portion of the stock in exchange for the boot. Generally speaking, this fictitious redemption is considered a sale or exchange (taxed as a capital gain) if it terminates or substantially reduces the shareholder's interest in the corporation. Otherwise, it's treated as a distribution.

One potential benefit of a merger is preservation of the target's deferred tax assets, such as net operating loss (NOL) carryovers, which otherwise might be lost.

A distribution isn't automatically taxed as a dividend, though. It's only treated as a dividend to the extent of the shareholder's proportionate share of the corporation's earnings and profits. Any distribution in excess of that amount is taxed as capital gain.

Deferred tax assets

One potential benefit of a merger is preservation of the target's deferred tax assets, such as net operating loss (NOL) carryovers, which otherwise might be lost. But watch out for the Unified Loss Rule (ULR). Although the rule is complex, it's important to consider it before a merger because it can result in the loss of valuable tax benefits.

Suppose, for example, that your bank wishes to acquire the stock of another bank that has substantial NOL carryovers. The target is part of a consolidated group owned by a common bank holding company (BHC), which will recognize a loss on the sale of the target's stock. The ULR, which is designed to avoid "duplicate losses," may wipe out the NOL benefits. One way to avoid this result is to negotiate with the BHC for a protective election that reduces its potential loss and preserves the target's NOL carryovers.

Due diligence

Many bank mergers are "statutory mergers." These transactions are relatively simple because their terms are generally dictated by state or federal law. One of the terms, however, is that the acquiring bank automatically assumes all of the target bank's liabilities, including tax liabilities. Thorough due diligence is critical to identify any potential liabilities for income, employment or other taxes that your bank may inherit from the target and to adjust the purchase price accordingly.

Alternatively, consider a "purchase and assumption agreement." These agreements are more complex, but they provide you with some flexibility to specify which liabilities you will and will not assume.

Be prepared

Mergers offer many potential benefits, from boosting capital to increasing market share to cutting costs. To get an accurate picture of a proposed merger's value, be sure you understand the tax implications. ▲

Sorting through restatements

Sometimes financial restatements simply correct mistakes

Mistakes on your borrowers' financial statements, requiring financial restatement, can happen: You might find accounting errors, noncompliance with Generally Accepted Accounting Principles or even simple clerical mistakes. But as you know from scandalous news stories, and perhaps from your own experience, financial restatements can also be a red flag for fraud or misrepresentation. It's your challenge as a lender to determine which is which.

A case in point

Let's look at a hypothetical example. Madison's Beauty Boutique was a large retail chain involved in acquisitions and complex lease arrangements for their many locations. The bank enabled Madison's to accomplish these transactions by lending funds on the company's past performance only — without an independent audit.

When Madison's offered its stock in the public market, the company's accounting practices fell under intense scrutiny. Management knew that potential investors would value the company higher if it showed reliable accounting and stronger internal controls. So, they engaged an independent accounting firm to perform an audit. The audit revealed that the company didn't follow complex leasing and revenue recognition rules or record acquisitions properly.

Madison's Beauty Boutique wasn't unethical, nor was it trying to mislead their financial statement readers — it just wasn't on top of today's increasingly complex accounting rules. A restatement was required.

Management combats stigma

To overcome the negative stigma associated with the restatement, Madison's management communicated regularly with all interested parties. Management also reassured employees, customers and suppliers that the company was in sound financial shape.

You can minimize your dependence on bad numbers by requiring independent audits for private borrowers.

The restatement took 10 months to complete and cost the company $67,000 in accounting fees. Four years of financial statements required restatement, generating a $1.8 million cumulative overstatement of earnings. The bank continually supported Madison's during the restatement process, and in four months it completed a successful public offering.

Reasons for restatement vary

According to a report from proxy research firm Glass, Lewis & Co., the leading causes of financial restatements include:

- Recognition errors, such as lease accounting errors and underreported compensation expense from backdated stock options,
- Misclassifications (for instance, shifting cash flows between investing, financing and operating on the statement of cash flows), and misclassifying balance sheet items as current or long-term, and
- Equity transaction errors, such as improper accounting for convertible securities.

Other leading causes were valuation errors related to common stock issuances and preferred stock errors; and the complex rules related to acquisitions, investments, revenue recognition and tax accounting.

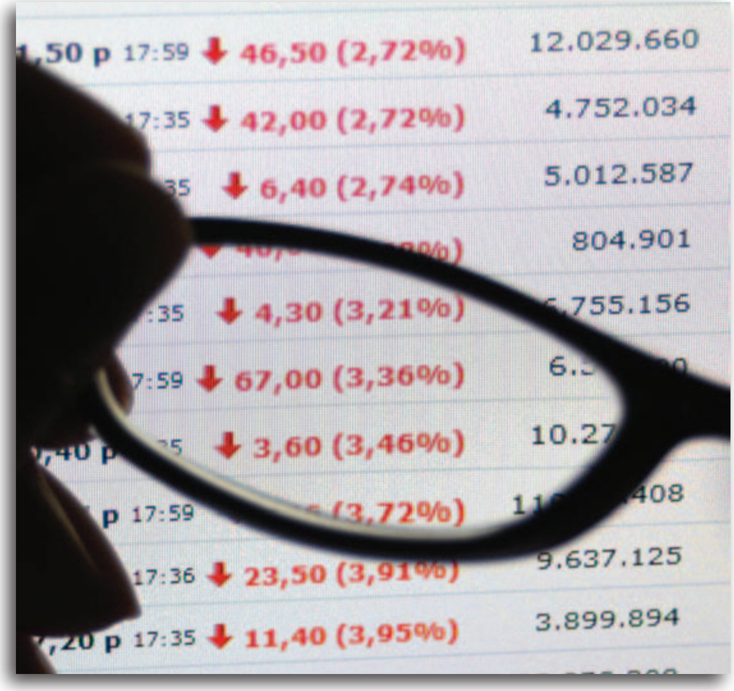
Do-overs decrease

According to Glass Lewis' most recent report, 75 companies with market capitalizations of at least $250 million reworked their financial statements. Some 172 companies had restated their information a year earlier. It's not known if the lower number indicates that companies are producing cleaner financial statements or if they're just not finding or reporting mistakes.

You can minimize your dependence on bad numbers by requiring independent audits for private borrowers. You also may request cost-effective internal control testing procedures for prospective and high-risk borrowers, such as those that engage in hedge accounting, issue stock options, use special purpose or variable interest entities, or consolidate financial statements with related parties.

Watch your step

Financial restatements can signal fraudulent financial reporting — or they can represent legitimate mistakes. Be sure to always analyze restatements carefully, and request an independent audit if you doubt the numbers' authenticity. ▲



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FAQs on interest rate risk

The Federal Financial Institutions Examination Council recently issued FAQs on interest rate risk (IRR) management that were jointly adopted by the various federal banking agencies. The FAQs address IRR exposure measurement and reporting, model risk management, stress testing, assumption development, and model and systems validation. They emphasize, however, that a particular bank's IRR management processes should be designed in the context of its complexity, risk profile, business model and scope of operations.

OCC provides foreclosure guidance

The Office of the Comptroller of the Currency (OCC) has issued Bulletin 2011-49 — *Guidance on Potential Issues With Foreclosed Residential Properties*. The guidance outlines a bank's obligations and risks related to foreclosed residential property (although it states that many principles also apply to commercial properties).

The guidance reviews legal, safety and soundness, and community impact considerations, noting that a bank's obligations may differ depending on whether the bank acts as owner of the foreclosed property, is the servicer or property manager, or is the securitization trustee. It also emphasizes the importance of understanding the requirements that Fannie Mae, Freddie Mac and HUD impose on servicers. The OCC expects banks to develop and implement "robust policies and procedures … to address risks associated with foreclosed (or soon to be foreclosed) properties."

FDIC scrutinizing bank insurance policies

FDIC examiners have been taking a closer look at banks' insurance policies. Insurance policies that provide directors and officers with coverage for certain civil monetary penalties (CMPs) may violate an FDIC rule against "prohibited indemnification payments."

Traditionally, banks have avoided this harsh result by purchasing separate CMP endorsements and having directors and officers pay the premiums. But according to anecdotal reports, some examiners maintain that policies issued in a bank's name violate the rule regardless of who pays the premiums.

If examiners challenge your bank's insurance arrangements, talk to your advisors about potential alternatives, such as having directors and officers purchase standalone policies.

CFPB proposes model mortgage statement

The Consumer Financial Protection Bureau (CFPB) is seeking comments on a prototype monthly mortgage statement. The Dodd-Frank act requires banks to provide borrowers with monthly statements that contain specified information about their loans. It also requires the CFPB to develop a model statement.

This summer, once the CFPB has a "polished" prototype, it plans to issue a proposed rule that specifies the information required in monthly mortgage statements and includes a model statement. According to the Bureau, banks will have some flexibility to tailor the model form to meet their needs.

You can download the prototype at http://www.consumerfinance.gov/wp-content/uploads/2012/02/20120213_cfpb_draft-periodic-mortgage-statement.pdf.

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