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P&G Banking

A D V I S O R

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Take the stress
out of stress testing

**Suspicious activity reports:
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to compare diverse customers

BANK Wire

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Take the stress out of stress testing

Stress testing can be a powerful tool for evaluating the impact of adverse external events on a bank's earnings, capital adequacy and other performance measures. It also can guide your institution's risk management and capital planning efforts.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires large banks — those with more than \$10 billion in assets — to conduct annual stress tests. But until recently, there's been some confusion about regulators' expectations for stress testing by community banks.

Late last year, the OCC issued supervisory guidance (OCC Bulletin 2012-33) that provides some clarity on this subject. Although community banks need not adopt the "holistic" stress testing required of large institutions, the OCC considers "some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis to be a key part of sound risk management for community banks."

Getting started

The OCC guidance recommends no particular stress testing method. But Appendix A to the guidance outlines several methods to consider, ranging from

transaction (individual loan) testing to portfolio testing to enterprise-level testing.

These methods generally involve scenario analysis: The bank applies historical or hypothetical scenarios to predict the impact of various events, including severe recession, loss of a major client or a localized economic downturn.

The right stress testing method depends on a particular institution's portfolio risk and complexity.

The right method — it can range from a simple spreadsheet to more sophisticated models — depends on a particular institution's portfolio risk and complexity. Most community banks can begin with a "top-down" approach at the portfolio level to determine whether additional analysis is needed. Using this approach, a bank applies estimated stress loss rates, under one or more scenarios, to pools of loans with common risk characteristics, focusing on concentrations of credit or loan portfolio segments that are significant to its overall business strategy.

Appendix B to the guidance provides a simple example illustrating this method. The bank begins by dividing the loan portfolio into pools, including "construction and development," "1-4 family housing," "nonfarm nonresidential property" and several other categories.

For each pool, it applies aggregate stress loss rates to quarter-end loan balances over a two-year stress test horizon. (According





CFPB ISSUES MORTGAGE ABILITY-TO-REPAY RULE

The Consumer Financial Protection Bureau's final rule amending Regulation Z, which will take effect Jan. 10, 2014, requires mortgage lenders to make a reasonable, good-faith determination of a borrower's ability to repay the loan. The rule, which implements several provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, also limits prepayment penalties.

The 800+ page rule requires lenders to consider certain underwriting factors — for example, the borrower's income, assets, and debt and credit history — and to verify this information with “reasonably reliable third-party records.” It also provides detailed guidance on how to evaluate these factors.



Regulation Z also provides a safe harbor under which lenders that offer “qualified mortgages” are presumed to be in compliance with the ability-to-repay requirement. Qualified mortgages must meet a number of requirements. For instance, they can't:

- Have terms that exceed 30 years,
- Provide for negative amortization, interest-only payments or balloon payments, or
- Charge points or fees that exceed 3% of the total loan amount (with certain exceptions).

In addition, qualified mortgages must have debt-to-income ratios over 43% and they can't be “no-doc” loans. ▲

OCC WARNS ABOUT INAPPROPRIATE RISK-TAKING

The OCC issued its Fall 2012 *Semiannual Risk Perspective* report, reflecting data as of June 30, 2012. Banks' efforts to increase profitability may lead to inappropriate risk-taking, and that's a key threat, according to the report.

For example, some community banks are responding to low market yields by increasing the maturities of their investment portfolios and purchasing more complex products, which can increase interest rate risk. Banks taking these actions should carefully analyze their vulnerability to interest rate shifts.

Other key risks include revenue growth challenges stemming from a slow economy, heightened market volatility, and the aftereffects of the housing-driven credit boom and bust (including a high number of distressed sales). The full report is available at occ.gov under “Publications / Other Publications/Reports.” ▲

FDIC PUBLISHES COMMUNITY BANKING STUDY

In December, the FDIC published the results of its *Community Banking Study*. The report begins by defining “community bank” and, rather than apply an asset threshold (traditionally, under \$1 billion), the FDIC defined the term based on a bank's limited geographic scope and engagement in traditional community banking lending and deposit activities. As a result, the study encompassed 330 banks that wouldn't have been classified as community banks based on asset size alone.

The study addresses structural change, the geography of community banking, comparative financial performance, balance sheet strategies and capital formation. It's available at fdic.gov; under “Featured Programs,” click on “Community Banking Initiatives.” ▲



Additionally, some tax accounting practices — such as expanded Section 179 and bonus depreciation deductions — may temporarily defer income taxes. So, consider the tax implications when reconciling different tax accounting methods.

Solo events

Lenders need to distinguish between historic performance results that represent potential ongoing earning power and those historic results that don't. If a one-time revenue (or expense) or gain (or loss) will temporarily distort the company's future earnings potential, you would add back expenses and losses (or subtract the revenues and gains) if they're not expected to recur.

If a borrower's plant was devastated by a hurricane or a borrower incurred a \$1 million equipment theft, for instance, you'd add back the extraordinary losses to get a clearer picture of normal operating performance. Or if the borrower won a \$5 million lawsuit, you'd subtract the gain. Other nonrecurring items might include discontinued lines or expenses incurred in an acquisition.

But go beyond just adjusting these charges. One-time charges — insurance claims and fraud losses are examples — could shed light on future risk factors. Ask

about the nature of these charges and any preventive measures the borrower has taken or will be taking to minimize the risk of recurrence.

Related-party transactions and unusual perquisites

Some closely held business owners are paid based on the company's cash flow or the owner's personal needs, not on the market value of services they provide. Many closely held businesses also employ family members, conduct business with affiliates and extend loans to company insiders. Because of this, you, as the lender, should identify all related-party transactions and inquire whether they occur at "arm's length." Also consider reconciling for unusual perquisites provided to insiders, such as season tickets to sporting events, college tuition or company vehicles.

An eye on the balance sheet

While most normalizing reconciliations are made to the income statement, many flow through to the balance sheet, which is often the lender's starting point in determining collateral values.

Suppose one manufacturer uses eight-year useful lives for its equipment, but another uses six-year useful lives for the same items. To create an equal basis of comparison, you might reconcile the first company's earnings downward to reflect its slower depreciation technique. In addition, the net book value of its equipment should be lowered to reflect its relatively inadequate depreciation deductions. These lender-made normalizing adjustments effectively make the first borrower appear less attractive than initially shown on its financial statements when compared to the second borrower.

Make informed decisions

Loan customers are diverse. They use different accounting methods, have different risk perceptions, operate in different locations and so on. But making normalizing reconciliations to financial statements lets you compare borrowers in the same or different industries to one another — or to themselves over time — to get a better understanding of a borrower's past and future earning power. ▲

to the guidance, the impact of stress events typically evolves over a two-year period or longer.) The example uses OCC benchmark data to estimate loss rates. But institutions also can use their own historical data from previous stress periods.

The results are used to estimate the potential impact of the scenario on earnings and capital. The earnings impact is calculated by taking estimated “pre-provision” net income for the stress period, deducting the estimated loss, deducting a provision to maintain adequate loan loss reserves and then adding an income tax benefit.

The example uses Tier 1 capital and Tier 1 leverage ratios to estimate changes in capital caused by a scenario. But banks also may examine changes in other capital measures.

Digging deeper

Depending on the complexity of a bank’s portfolio and the results of initial testing, additional analysis may be appropriate. In some cases, a “bottom up,” loan-by-loan analysis may be valuable. And for other cases further segmentation of certain loan pools — such as commercial mortgages or construction loans — may be useful. For instance, an institution might segment commercial mortgages by debt-service-coverage or loan-to-value ratios to reflect different levels of risk.

The guidance also refers to the banking agencies’ 2006 guidance on commercial real estate (CRE) concentrations. (See “Managing CRE risk” at right.) The OCC expects banks that exceed the concentration thresholds established in that guidance to use more robust stress testing, taking into account property-specific characteristics and variables.

Appendix C provides an extensive list of CRE-related stress-testing factors — interest and capitalization rates, collateral values, marketing costs, energy costs, vacancy rates and others — for various property types.

Taking action

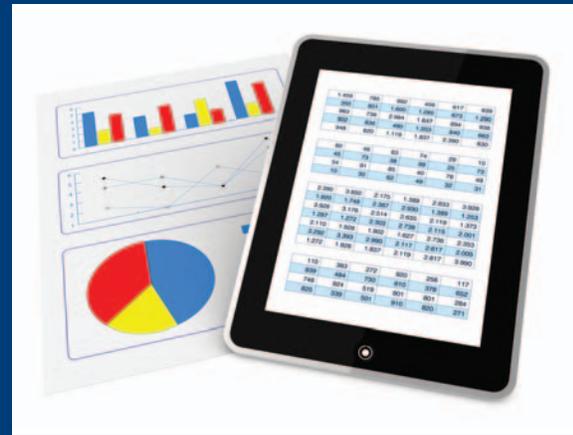
Community banks can use portfolio-level stress testing to establish reasonable risk tolerances, set concentration limits, adjust strategies, and plan for and maintain

Managing CRE risk

The recent OCC guidance isn’t the first time banking regulators have encouraged community banks to conduct stress tests. In 2006, the FDIC, OCC and Federal Reserve published interagency guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. Regulators expect institutions to employ enhanced risk management techniques, including stress testing, if they exceed or are approaching these thresholds:

- Total reported loans for construction, land development and other land represent 100% or more of total capital, or
- 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.

In its recent guidance, the OCC says that banks exceeding these thresholds “are expected to use more robust stress testing practices to effectively manage the concentrations and maintain adequate capital.”



adequate capital levels. If the results reveal significant risks or vulnerabilities, institutions should take action to mitigate them. This can be achieved by, for example, increasing portfolio monitoring, adjusting underwriting standards, selling or hedging assets, or increasing capital.

According to the OCC, community banks that have incorporated stress testing into their planning typically demonstrate an ability to withstand negative market developments more effectively than other banks do. ▲

Suspicious activity reports: Are you using “key terms”?

The Financial Crimes Enforcement Network (FinCEN) is currently completing the most recent transition for e-filing of suspicious activity reports (SARs). Make sure your staff is trained to use the new procedures.

It’s also a good time to review your institution’s SAR policies and procedures. One detail that banks often overlook is FinCEN’s list of key terms to include in the narrative section of the SARs. Using these terms helps law enforcement officials detect fraud and money laundering more quickly, which, in turn, helps protect your bank’s customers.

E-filing

E-filing offers several benefits for banks, including enhanced security, accelerated submission of data to FinCEN and reduced compliance costs. In addition, the ability to prepare SARs using online forms makes the filing process more user-friendly. By providing interactive instructions and highlighting critical data fields, the online form helps users avoid errors and omissions.

Key terms make it easier for law enforcement and regulatory investigators to search SARs and identify suspicious activities more quickly.

To enhance the value of SARs, the online form contains several new data fields — including a customer’s gender, NAICS code and Internet presence (e-mail, website address). It also allows users to include spreadsheet attachments in the SAR’s narrative section.

Using key terms

From time to time, FinCEN issues advisories to provide banks with guidance on preparing SARs related to certain



activities. Often, these advisories request that banks include certain key terms — such as “account takeover fraud,” “elder financial exploitation” or “foreclosure rescue scam” — in their SAR narratives. Unfortunately, many banks are unaware of these terms.

Key terms make it easier for law enforcement and regulatory investigators to search SARs and identify these activities more quickly. By including these terms in your SAR narratives, you can help accelerate the investigative process, minimizing losses to your bank and its customers. Here are a few examples:

Third-party payment processors. According to Advisory FIN-2012-A010, nonbank or third-party payment processors may present a heightened risk of money laundering, identity theft, fraud and other illicit transactions. The advisory provides guidance on detecting these transactions and lists several red flags, such as payment processors that maintain accounts at more than one financial institution or experience a high number of consumer complaints.

When reporting suspicious activities involving third-party payment processors, banks should 1) check the appropriate box on the SAR form to indicate the type of suspicious activity, and 2) include the key term “Payment Processor” in both the narrative and “subject occupation” portions of the SAR.

Mexico currency restriction. Advisory FIN-2010-A007, updated last year by Advisory FIN-2012-A006, outlines certain restrictions on the ability of Mexican financial institutions to conduct transactions in U.S. currency. Banks that report suspicious activity related to these restrictions should include the term “MX Restriction” in their SAR narratives.

Commercial real estate fraud. Advisory FIN-2011-A007 provides examples and potential indicators of several types of commercial real estate fraud, including misrepresentation, misappropriation of funds, bank insider collusion and “flipping” schemes. Banks reporting suspicious activity involving commercial real estate fraud should include the key term “CREF” in their SAR narratives.

For the complete list of key terms, including links to the relevant advisories, go to fincen.gov and click on the “News Room / Advisories-Bulletins-Fact Sheets” tabs, where you’ll find the “Suspicious Activity Report (SAR) Advisory Key Terms” link.



Review your program

To protect your institution and its customers from fraud and other illicit activities, review the SAR program you have in place. Make sure that policies and procedures for monitoring and reporting suspicious activities are sufficient in light of your bank’s particular risk profile. And include the appropriate key terms in the SARs to speed the investigative process. ▲

Borrowers are *not* created equal

Use financial statement reconciliations to compare diverse customers

“Normalizing” reconciliations to the income statement and balance sheet is necessary when comparing diverse borrowers. A thorough knowledge of accounting helps lenders prepare dissimilar customers’ financial statements for apples-to-apples comparisons and to aid in underwriting decisions. Here’s a basic explanation of this accounting tactic.

Varied accounting methods

Even within the broad confines of GAAP, it’s rare for two companies to follow exactly the same accounting practices. When you compare a borrower’s practices to those of a competitor or to industry benchmarks, it’s important to understand how they report transactions.



Some small firms, for example, might report earnings when cash is received (cash basis accounting), but its competitor might record a sale when it sends out the invoice (accrual basis accounting). Differences in inventory reporting, pension reserves, depreciation methods and cost capitalization vs. expensing policies also are common.