P&G Banking ADVISOR

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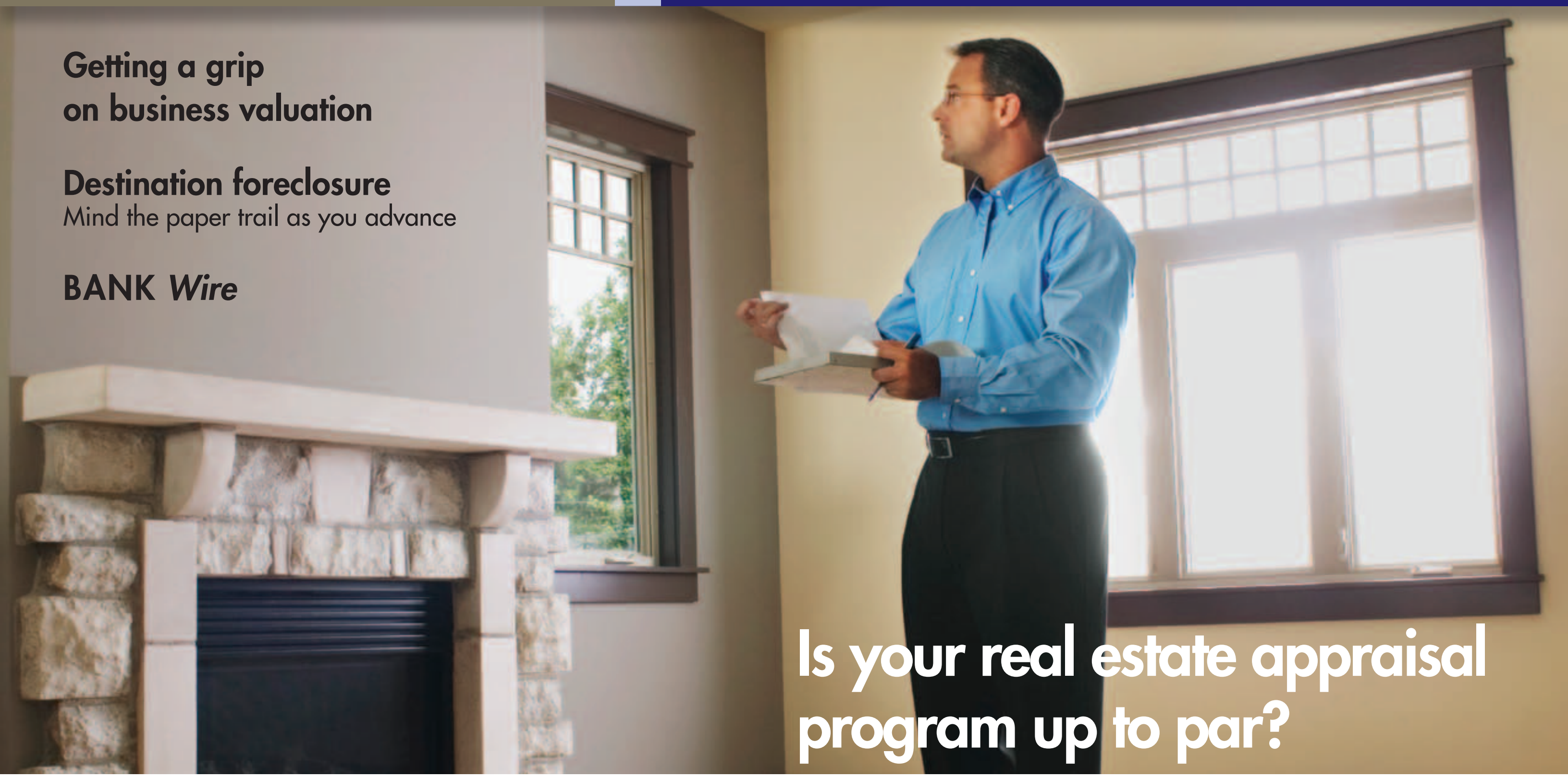


Getting a grip on business valuation

Destination foreclosure
Mind the paper trail as you advance

BANK *Wire*

Is your real estate appraisal program up to par?

P&G Associates

www.pandgassociates.com 877.651.1700

Is your real estate appraisal program up to par?

In the wake of the financial crisis, lawmakers and banking regulators have set their sights on real estate collateral valuation practices. To ensure that your institution meets examiners' expectations, it's wise to conduct an assessment of your appraisal and evaluation program. Start by reviewing the *Interagency Appraisal and Evaluation Guidelines,* which were revised in late 2010.

Which transactions are covered?

The guidelines apply to appraisals and evaluations in connection with all real estate–related financial transactions originated or purchased by regulated institutions, whether for their own portfolios or as assets held for sale. They cover residential and commercial mortgages, capital markets groups, and asset securitization and sales units.

Most transactions valued over $250,000 require appraisals, though certain transactions — listed in Appendix A to the guidelines — are exempt. In addition to the exception for transactions at or below the $250,000 threshold, the exceptions include business loans secured by real estate for less than $1,000,000. This doesn't include repayment from the rental income or sale of the real estate, extensions of existing credits, loans not secured by real estate, and transactions guaranteed or insured by the U.S. government.

The exemptions are limited, so be sure to scrutinize transactions to determine whether risk factors or other circumstances require an appraisal. Also, some exempt transactions require a less formal "evaluation." (See "Handling evaluations with care" on page 3.)

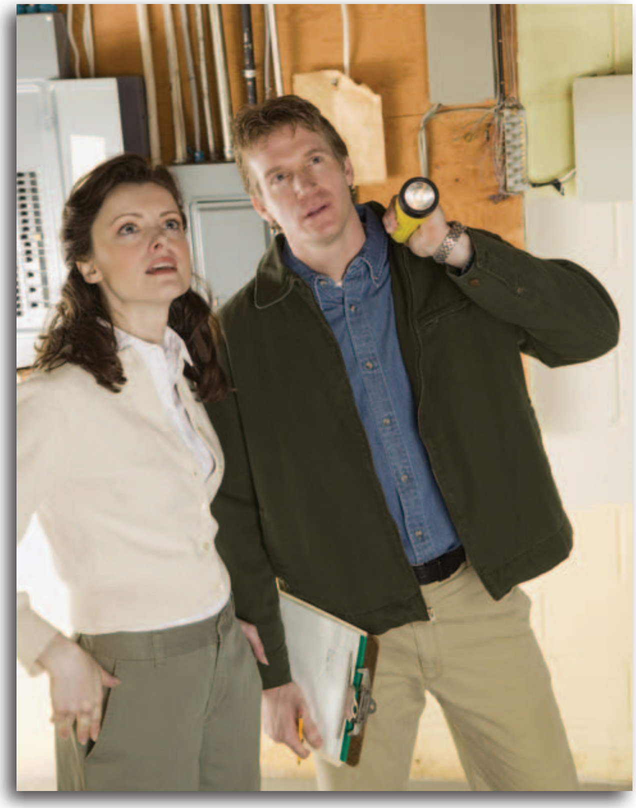
What makes a program effective?

Your institution is responsible for developing an effective collateral valuation program. Key requirements include:

Independence. Your program should be isolated from influence by loan production staff. Individuals who order, review, and accept appraisals or evaluations should have reporting lines independent of loan production staff. Appraisers and individuals performing evaluations ("evaluators") need to be independent of loan production and collection and should have no interest in the transaction or property. Special rules apply to smaller institutions that lack the staff needed to separate their collateral valuation programs from the production process.

For mortgages and other loans secured by a principal dwelling, review recent amendments to Regulation Z that impose strict independence and conflict-of-interest requirements on appraisers.

Valuator selection. Establish criteria for selecting, evaluating and monitoring appraisers and evaluators, and for documenting their credentials. Among other things, ensure that those selected are qualified, competent and independent, and that appraisers hold appropriate state certifications or licenses.



Select and engage appraisers *directly,* although appraisals prepared for other institutions may be used if certain requirements are met. Approved appraiser lists are permitted, provided you establish safeguards to ensure that list members continue to be qualified, competent and independent.

The suitability of your appraisal program depends on your institution's risk profile.

Minimum appraisal standards. Appraisals should conform to the Uniform Standards of Professional Appraisal Practice, although stricter standards may be required by safe and sound banking practices. Reports should be in writing and provide sufficient detail — according to the transaction's risk, size and complexity — to support the credit decision. Appraisers should analyze appropriate deductions and discounts (detailed in Appendix C of the guidelines) for proposed construction or renovation, partially leased buildings, nonmarket lease terms and tract developments with unsold units.

What else should you know? In addition to the above, your program should:

- Facilitate credit decisions by ensuring timely receipt and review of appraisal or evaluation reports,
- Develop criteria for determining whether existing appraisals or evaluations may be used to support subsequent transactions,
- Implement internal controls that promote compliance,
- Establish criteria for monitoring collateral values, and
- Establish criteria for transactions not otherwise covered by appraisal regulations.

If you outsource valuation functions, your institution remains responsible for all appraisals and evaluations. The guidelines discuss the resources, expertise, controls and due diligence procedures your institution needs to identify, monitor, and manage risks associated with these outsourcing arrangements.

Stay tuned

As you review your collateral valuation program, be sure to monitor relevant regulatory activities. Further revisions to the guidelines will be needed as the banking agencies adopt new regulations to implement provisions of the Dodd-Frank Act.

Keep in mind that the suitability of your program depends on your institution's risk profile. For example, if your institution has a significant concentration of real estate loans, offers high-risk loan products or is poorly capitalized, examiners will expect a more vigorous program and scrutinize your practices more intensely. ▲

Handling evaluations with care

Even if a transaction is exempt, you might be required to obtain an evaluation of collateral in lieu of an appraisal for:

- Transactions at or below the $250,000 appraisal threshold,
- Business loans secured by real estate, and
- Extensions of existing credits.

Evaluations may be performed by appraisers, real estate lending professionals and others with appropriate education, expertise and experience. The evaluation should contain sufficient details on the analysis, assumptions and conclusions to support the credit decision, including any market sales databases or previous sales data used. Appendix B to the guidelines provides guidance on using analytical methods and technological tools to perform evaluations.

Even though evaluations are permitted for certain transactions, it's important to review each transaction on a case-by-case basis and consider obtaining appraisals when higher-risk loans or borrowers are involved. If you're advancing new funds on existing credits, obtain an appraisal if there have been obvious, material changes in market conditions or the property's physical condition.

Getting a grip on business valuation

Business valuation reports likely slide across your desk all the time. This professional tool can help you fill in the blanks when evaluating a loan customer — whether the individual is eyeing an acquisition or filing bankruptcy. But do you understand the building blocks that lead to a valuation report on your customer's business?

How professional valuators come to their conclusions depends on many variables. Here are some basic tenets to keep in mind as you review business valuation reports.

Defining "value"

The term "value" can have many different meanings. *Strategic (or investment) value* refers to the perceived value to a specific investor. A business seeking to expand, for example, might pay a premium to acquire a supplier. Strategic value depends on an investor's individual requirements and expectations.

An important benchmark in negotiating deals is *fair market value*. Essentially, this is the price the "universe" of potential buyers and sellers would agree on for a business interest. Fair market value assumes no compulsion to buy or sell and reasonable knowledge of all relevant facts. Beware of deals where strategic value is significantly higher than fair market value. Many buyers overestimate the value of synergies.

Another common standard of value is *fair value*. In an accounting context, it's similar to fair market value, except that fair value is often dictated by courts or a jurisdiction. In financial reporting, fair value only considers market participants active in the principal (or most advantageous) market.

Accountants use the term "fair value" when, for financial reporting purposes, they value assets and liabilities — such as asset retirement obligations, long-lived assets and goodwill. And some distressed borrowers reported goodwill impairment during the recession. Goodwill impairment occurs when the fair value of acquired goodwill is lower than the amount shown on the borrower's balance sheet. These write-offs usually foreshadow financial problems.

3 approaches

In much the same way they value real estate, appraisers apply three approaches to valuing a business.

1. Cost. With the *cost (or asset-based) approach,* the value of a business is the difference between its assets and liabilities. For example, an appraiser might revalue the amounts shown on a company's balance sheet. This approach is difficult to use on companies with significant intangible value. It's typically reserved for holding companies and others that rely exclusively on hard assets.

2. Market. The *market approach* generates pricing multiples from sales of comparable (or guideline) companies. Here, value is a function of selling price and a financial metric, such as annual revenues or last year's earnings before interest, taxes, depreciation and amortization.

Public pricing data can be obtained from SEC documents (for controlling interests) and daily stock market quotes (for minority prices). Alternatively, private deal terms may be obtained from proprietary databases for controlling interests.

Selection criteria for comparables might include transaction date, financial performance, industry and size. Finding a meaningful sample of comparables for some companies — especially niche specialists — can be difficult.

3. Income. Using the *income approach,* valuators project cash flows and then discount them back to their net present value. Discount (or capitalization) rates are based on the company's risk. High-risk businesses are assigned a higher discount rate, which equates to a lower value (and vice versa).

The income approach may be difficult for laypeople to understand. Sophisticated buyers and sellers are more likely to use this approach. It's often the preferred method for startups and companies with significant intangible value.

Tapping the experts

Methods and definitions explain some of the "science" underlying business valuations. But accurate appraisals also require finesse and qualitative assessment. Experienced valuators understand subtle valuation nuances and potential pitfalls, so it's to your advantage to use one. ▲

Destination foreclosure

Mind the paper trail as you advance

Mortgage foreclosures are an unfortunate part of life in today's banking industry. Following the 2010 scandal involving improper foreclosure policies and practices at some of the nation's largest banks, federal regulators are taking a closer look at the process.

All financial institutions should review their foreclosure processes and documentation to be sure they're dotting all the i's and crossing all the t's. Improper or missing paperwork can delay a foreclosure, expose an institution to litigation or regulatory inquiries, and damage its reputation.

Common snafus

It's rare for an institution to foreclose against a borrower who isn't actually in default. But even if foreclosure is appropriate, the process can be derailed by poor execution and documentation of foreclosure proceedings.

Also, in some cases, obstacles to foreclosure may arise in connection with mortgage loans that are securitized or otherwise transferred by sale. This can happen, for example, if inadequate or improper negotiation or transfer of ownership paperwork causes a break in the chain of title between the loan's originator and the party attempting to foreclose. Often, the only solution is for the original seller to buy back the loan according to indemnification provisions in the sale agreement.

In April 2011, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Reserve System completed their *Interagency Review of Foreclosure Policies and Practices* at 14 large, regulated mortgage servicers. The agencies found several significant weaknesses:

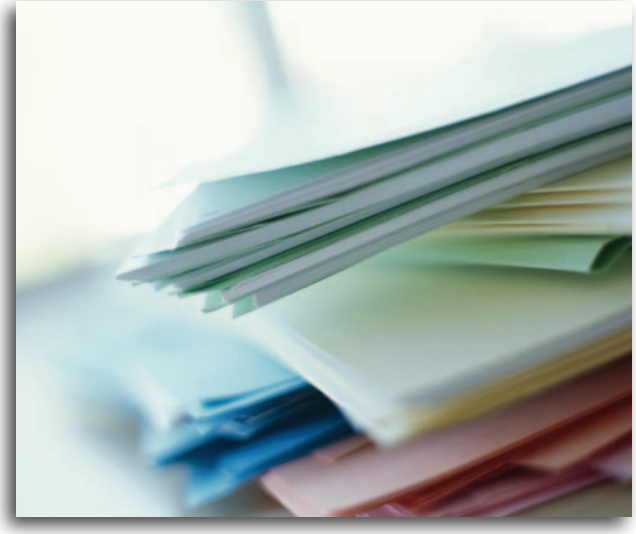
- Underdeveloped and insufficient foreclosure process governance, including inadequate policies, procedures and controls, inadequate monitoring, and insufficient audit trails,
- Organization and staffing of foreclosure units inadequate to handle the volume of foreclosures,
- Improper affidavit, notarization and documentation practices, including signatures on foreclosure affidavits by individuals without adequate personal knowledge of the affidavits' contents or accuracy,
- Deficiencies in third-party vendor management, including inadequate oversight, document retention, guidance, policies, procedures and contracts, and
- Weaknesses in quality control and internal auditing procedures.

As a result of their review, the agencies initiated formal enforcement actions against the 14 institutions. Among other directives, the institutions were required to establish a compliance program for their mortgage-servicing and foreclosure operations and to retain independent firms to review their residential foreclosure actions from the beginning of 2009 through the end of 2010.

No "robo-signers"

One of the most common weaknesses in institutions' foreclosure practices involves "robo-signers." To expedite the foreclosure process, many institutions have protocols that allow individuals to sign foreclosure affidavits without ensuring that the signers personally review the supporting documentation or have knowledge of the underlying facts.

Improper affidavit practices give borrowers ammunition to challenge foreclosure proceedings — in both judicial (court-supervised requiring the lender to bring a court action to foreclose) and nonjudicial (little or no court oversight in states where foreclosures are covered by state statute) foreclosure states, as well as in bankruptcy court.



If a challenge is successful, a borrower can avoid or delay foreclosure, often for a significant period of time.

Generally, robo-signing is less of an issue at community banks. These institutions typically work closely with their borrowers to avoid foreclosure. But if foreclosure becomes necessary, it's important to ensure that affidavit protocols and other procedures comply with applicable laws and regulations.

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Review your program

Financial institutions of all sizes should review their foreclosure programs to ensure they'll withstand challenges by borrowers and survive regulatory scrutiny. No institution wants to foreclose on a mortgage, but when foreclosure is unavoidable, well-designed policies and practices will help avoid delays and unnecessary costs for all involved. ▲

BANK *Wire*

FDIC FIELDS QUESTIONS ABOUT OVERDRAFT GUIDANCE

The FDIC's guidance on overdraft fees may be less strict than many bankers feared, according to the agency's recently published FAQs on supervisory guidance, which was issued by the agency in November.

One provision that caused some concern, for example, requires banks to monitor customers' accounts for excessive use of overdraft protection (more than six overdrafts in a 12-month period) and take "meaningful" steps to advise those customers on less costly alternatives. The supervisory guidance suggested that this would require a face-to-face meeting or phone call with the customer.

The FDIC clarifies that banks have other options for meeting these obligations, including "enhanced periodic statements." These statements alert a customer to multiple overdraft fees and provide contact information for a customer service representative who can supply information about cheaper alternatives. ▲

SAFE ACT DEADLINE

Under the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE), federally insured depository institutions must ensure that all mortgage loan originators in their employ are registered with the new Nationwide Mortgage Licensing System and Registry (NMLS). The registration deadline is July 29, 2011. For more information, visit the NMLS Resource Center at http://mortgage.nationwidelicensingsystem.org. ▲

TRAINING STAFF ON FDIC COVERAGE

In an effort to better inform depositors, an FDIC proposal requires certain employees of insured institutions to be trained on the fundamentals of FDIC deposit insurance coverage. The rule also would require employees to provide certain information to customers that deposit more than the $250,000 Standard Maximum Deposit Insurance Amount. ▲

REG CC AMENDMENTS PROPOSED

The Federal Reserve Board has proposed several amendments to Regulation CC, *Availability of Funds and Collection of Checks*. The proposal would encourage banks to clear and return checks electronically. To do this, the proposal provides that a bank returning an item unpaid to the bank where it was deposited wouldn't need to meet the expeditious 2-day/4-day deadline unless the depository bank agrees to receive returned checks electronically.

Therefore, to protect itself from the risk of loss, depository banks will want to accept electronic returns rather than waiting longer for items to be returned. The amendments also would permit the bank responsible for paying a check to require that checks presented to it for same-day settlement be presented electronically.

The proposal shortens the period for an exception hold to four business days. ▲

P&G Associates

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.

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P&G Associates

www.pandgassociates.com

Headquarters:
646 US Highway 18
East Brunswick, NJ 08816

10 South Riverside Plaza
Chicago, IL 60606

80 S.W. 8th Street
Suite 2000
Miami, FL 33130

877.651.1700