P&G Banking ADVISOR

Summer 2012

Managing outsourcing risks

Wealth management programs
How to "carry" a millionaire

BANK *Wire*

Cross-collateralization: Handle with care

P&G Associates

www.pandgassociates.com 877.651.1700

Cross-collateralization: Handle with care

In the current banking environment, risk management is critical, particularly when it comes to a bank's lending activities. One potential strategy for reducing risk associated with commercial loans is cross-collateralization — that is, using multiple properties to secure a loan associated with one property.

Cross-collateralization can provide significant benefits, but the strategy raises several issues banks must consider before adopting it. It also may raise issues in a nonlending context. (See "Watch out for IRA cross-collateralization" on page 3.)

Accounting concerns

Generally, when interest payments on a loan are significantly overdue and collection of principal is deemed unlikely, the loan must be placed on "nonaccrual status." If a bank experiences an increase in nonaccrual loans, it will likely be forced to increase its reserves for loan losses, which may hurt its profits.

> If a bank experiences an increase in nonaccrual loans, it will likely be forced to increase its reserves for loan losses, which may hurt its profits.

In some cases, cross-collateralization can cause multiple loans to be placed on nonaccrual status, even if some of the loans are still performing. The OCC, in its March 2012 *Bank Accounting Advisory Series* (BAAS), offers several examples that illustrate the potential impact of cross-collateralization on nonaccrual status.

One example involves a real estate developer that has two loans with a bank for two separate projects. Loan A is current and the bank expects full repayment of principal and interest. But loan B is placed on nonaccrual status.

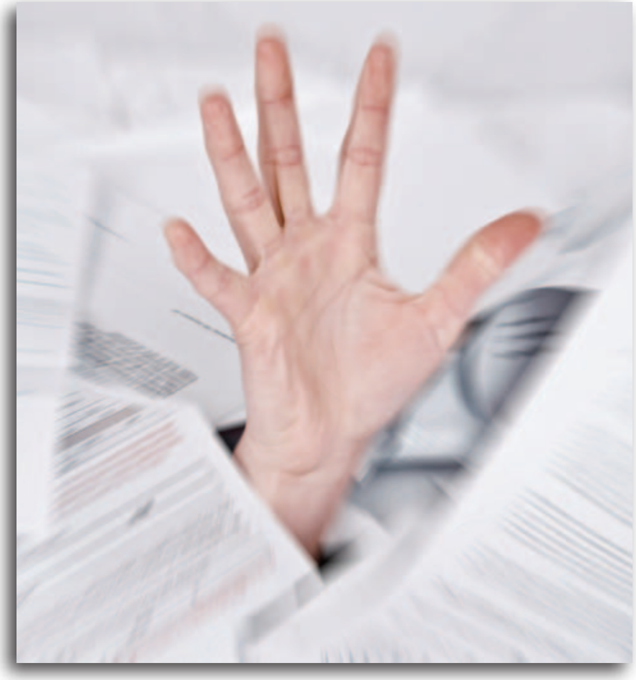
According to the BAAS, placing one loan on nonaccrual status doesn't automatically require the bank to place the other loan on the same status. The guidance emphasizes that the obligors on the two loans are separate corporations wholly owned by the developer and there's no cross-collateralization or personal guarantees. If the bank subsequently negotiates a cross-collateralization agreement with the developer, must loan A also be placed on nonaccrual status? According to the BAAS, by entering into a cross-collateralization agreement, the bank is merely taking steps to improve its position relative to the borrower. It need not place loan A on nonaccrual status if cross-collateralization doesn't change the repayment pattern of the loans or endanger loan A's full repayment.

In another example, loans A and B are related to separate real estate projects, are personally guaranteed by the developer and were initially cross-collateralized. Project A has the cash flows to repay loan A in full but no excess to meet a shortfall on loan B, which is past due.

According to the OCC, if the developer has the ability and intent to make the payments on both loans, the bank could maintain both loans on accrual status. If the developer lacks the ability and intent to make the payments, both loans should be placed on nonaccrual status.

Because the loans are cross-collateralized, collectibility should be evaluated on a combined basis. The developer, as guarantor, is the ultimate repayment source for both loans, so placing only loan B on nonaccrual status wouldn't reflect that the collectibility of the entire debt is in doubt.

Another example indicates that the outcome might be different if loan A has "a consistent dedicated source of repayment" and the bank can support the assertion that cross-collateralization won't affect loan A's timely repayment.



Considerations when restructuring debt

Under current accounting standards, if restructured loans are considered troubled debt restructurings (TDRs), they may result in additional valuation allowances or losses on a bank's financial statements. Generally, a restructuring is a TDR if a bank grants a concession to a borrower experiencing financial difficulties.

Some banks use cross-collateralization in an attempt to avoid TDR status on reworked loans. They might, for instance, defer loan payments or reduce the interest rate in exchange for additional collateral.

To avoid TDR status, however, the bank must ensure that the additional collateral is sufficient to compensate the bank for the other terms of the restructuring. Accounting standards provide guidance but don't give examples of every possible set of facts to make this determination. So, when in doubt, have your accounting advisor evaluate the terms of a proposed restructuring.

Weigh the risks

Cross-collateralization can be an effective way to reduce risk, but it also can introduce new risks into the equation. Community banks should carefully weigh the benefits of cross-collateralization against its potential pitfalls. ▲

Watch out for IRA cross-collateralization

Banks and brokerage firms sometimes require IRA owners to sign cross-collateralization agreements. Typically, these agreements provide that the owner's non-IRA accounts may be used to cover a shortfall in the IRA — for example, if the IRA experiences investment-related losses, or incurs fees that exceed the amount in the IRA. Similarly, the IRA may be used to cover shortfalls in non-IRA accounts.

Recently, the U.S. Department of Labor issued two advisory opinions stating that these arrangements are prohibited transactions that endanger an IRA's tax-exempt status. The DOL is considering further action on this issue.

In response, the IRS has provided temporary relief to IRA owners who've entered into cross-collateralization agreements. The Service won't treat these agreements as a taxable event provided there's been no execution or other enforcement against the IRA assets.

Managing outsourcing risks

It's increasingly common for small and midsize banks to outsource operational functions or to rely on third parties to provide products or services to bank customers. Banks often outsource activities such as data processing and other IT functions, card processing, mortgage processing, call centers, and even Bank Secrecy Act / Anti-Money Laundering (BSA/AML) compliance.

Outsourcing to third parties offers significant benefits: Shifting day-to-day responsibility for certain noncore functions frees up management time to focus on core functions and strategic initiatives. It also can produce significant cost savings. With access to sophisticated technology and expertise — and the advantage of economies of scale — third-party providers typically can perform these functions far more cost-effectively than an individual bank could.

If you're considering outsourcing, or are already doing so, make sure you have policies and procedures in place to manage the risks associated with the use of third parties.

Review regulatory guidance

A good place to start is by reviewing FDIC Financial Institution Letter 44-2008, "Guidance for Managing Third-Party Risk." The Guidance emphasizes that a bank's board of directors and senior management are ultimately responsible for managing outsourced activities and identifying and controlling the risks associated with third-party relationships, just as if those activities were handled in-house.

The Guidance summarizes many of these risks, noting that some are associated with the activity itself — regardless of who performs them — while other risks are heightened by the involvement of a third party. For example, missteps by a third party or negative publicity involving one can increase a bank's reputation risk. And compliance risk is a big concern, particularly if a third party experiences security breaches involving bank customer information or otherwise fails to act consistently with the laws, regulations and ethical standards that apply to banks. Outsourcing may also raise concerns about strategic, operational, transaction and credit risks.

> Make sure you have policies and procedures in place to manage the risks associated with the use of third parties.

It's also important to consider consumer protection laws, particularly prohibitions on unfair, deceptive or abusive acts or practices. In a recent bulletin, the Consumer Financial Protection Bureau (CFPB) said it expects supervised banks and nonbanks to conduct thorough due diligence and take other steps to ensure that service providers comply with consumer protection laws. Although most community banks don't fall under the CFPB's direct supervision, it's a good idea to follow the Bureau's guidelines, which may evolve into industrywide best practices in the future.

Create a process

The FDIC Guidance outlines four essential elements of an effective third-party risk management process:

1. Risk assessment. Ensure that a proposed outsourcing relationship is consistent with the bank's overall business strategy. Analyze the benefits, costs, legal aspects and potential risks associated with the third party being considered and then compare the proposed relationship with alternative methods of performing the activity or providing the product or service. Review management's ability to provide adequate oversight and management of the proposed relationship.

2. Due diligence. Conduct comprehensive due diligence when selecting a third-party provider and do so periodically during the relationship, particularly when the contract is up for renewal. The Guidance lists several items the bank might review, noting that the scope and depth of due diligence is directly related to the importance and magnitude of the relationship. For example, a third party dealing with sensitive data would require more intensive due diligence than one involved with a low-risk activity.

3. Contract structuring and review. The parties' respective expectations and obligations should be outlined in a written contract, with board approval of any material third-party relationships and review by appropriate legal counsel. The Guidance contains a detailed list of items that should be addressed, including compliance with applicable law, bank access to third-party records, performance standards and audit requirements.

4. Oversight. To minimize its risk exposure, the bank should maintain adequate oversight of third-party activities. Among other things, an effective oversight program should provide for board approval and periodic review of significant outsourcing arrangements and management review of third-party operations.

Be prepared

If your bank uses outsourcing, be prepared to demonstrate to bank examiners that you're managing third-party risk effectively. Simply having a program in place isn't enough —you'll need to provide documentation of the four elements described above. ▲

Wealth management programs

How to "carry" a millionaire

As your community bank looks for new sources of revenue, keep in mind its greatest advantage over larger banks — its ability to build long-term customer relationships. Money management services, particularly for those with ample funds to invest, can grow customer relationships while enhancing your revenue stream.

What are the pluses?

Developing a wealth management program — with offerings geared to the investment end of fee-based services — can benefit your bank in a couple of ways. Profit margins are typically greater for investment services than for traditional banking services. And you develop another noninterest income source, thus diversifying your bank's revenue sources and making it less volatile.

Community banks have a strong competitive advantage in that many high-net-worth clients seek a one-on-one relationship with a trusted advisor who can guide them in growing their wealth in a cost-efficient manner. Your bank is in a better position to meet this need than are your larger counterparts because of its strong client relationships. Those close ties also can enable you to cross-sell services more easily.

So how wealthy of a customer should you target? Industry analysts recommend entrepreneurs, corporate executives, doctors, lawyers and others with $1 million to $3 million in assets who have investment potential.

Is it work-intensive?

If you worry that high-net-worth clients may require individual attention and creative solutions that could make for an expensive wealth management program, you're right — to an extent.

Fortunately, automated technologies can provide a comprehensive review of a customer's entire wealth management program, allowing your employees to give quick, efficient service and strong guidance. These tools can be used in several areas, including wealth planning, portfolio allocation, management and rebalancing, and reporting.

Although high-net-worth clients may still require a lot of work, automated technologies can provide a good amount of relief.

What's a winning strategy?

While promoting your wealth management program externally, be sure to analyze how the new offerings affect your bank's other products and services. A winning strategy is to integrate your wealth management strategies with other offerings.

For example, community banks can use their highly coveted customer knowledge to better integrate services such as wealth planning; portfolio allocation, management and rebalancing; performance measuring; and reporting.

This isn't to say that you shouldn't build a brand around the new wealth management program. In fact, a marketing program for your target client base is well advised. But connecting a new wealth management program with the rest of your products will solidify your customer base.

What about manpower?

Investment advising is an important aspect of wealth management services, but finding affordable, experienced wealth management advisors in a high-demand market is no small feat.

Although high-net-worth clients may still require a lot of work, automated technologies can provide a good amount of relief.

One strategy is to create an entirely new wealth management department, which could be attractive to entrepreneurial-minded professionals who'd like to build a program from the ground up. Bringing such professionals in house could prove useful in training existing employees.

Also, consider partnering with an outside firm to lessen time and start-up expenses. If your bank has, for example, a trust department, you can delegate trust administration responsibilities to a law firm. This will leave your employees with time to focus on asset management and retirement planning.

Take advantage of the market

The continued aging of the baby boomers is one of the most important demographic trends of the decade. With typically greater incentives to save, this population calls for enhanced banking services. Let your bank be the one to provide them. ▲

B A N K

Wire

JOBS ACT RAISES SEC THRESHOLD

The recently enacted Jumpstart Our Business Startups (JOBS) Act contains some good news for community banks and bank holding companies. The act raises the threshold for SEC registration to 2,000 shareholders of record. Previously, banks with more than $10 million in assets and more than 500 shareholders of record were required to register with the SEC and file periodic reports, regardless of whether they marketed their securities publicly. Many community banks have struggled to keep their shareholder count under 500 to avoid SEC registration.

The JOBS Act also increases the threshold for "deregistering" securities with the SEC from 300 to 1,200 shareholders of record. This provides an opportunity for many public banks to deregister and avoid future SEC filing requirements. ▲

WATCH OUT FOR ATM LAWSUITS

Class action lawsuits recently were filed against several community banks alleging violations of the Electronic Fund Transfer Act. The act requires ATMs to display a physical notice of ATM fees in addition to the notice that appears on the screen when a customer makes a withdrawal. There was a similar rash of lawsuits in previous years, including dozens filed by a retired couple that drove around looking for noncompliant ATMs and documenting the violations with photos.

Plaintiffs in these lawsuits may recover damages up to the lesser of $500,000 or 1% of the ATM operator's net worth, plus attorneys' fees and costs. But a bank can defend itself by demonstrating that noncompliance was caused by a "bona fide error" and that it maintained "procedures reasonably adapted to avoid any such error." ▲

CFPB EASES COMPLAINT PROCESS

The Consumer Financial Protection Bureau (CFPB) is now accepting complaints about bank accounts, including checking accounts, savings accounts, certificates of deposit and related services. This expands the role of the CFPB, which started taking consumer complaints regarding credit cards, mortgages and other home loans last year.

In addition to filing complaints by snail mail, fax or telephone, consumers can file complaints — and check their status — using the CFPB's website at consumerfinance.gov/complaint. ▲

OCC CONCENTRATING ON CONCENTRATIONS OF CREDIT

One of the most important regulatory issues for banks today is compliance with examiners' guidelines about risky concentrations of commercial real estate loans. The Office of the Comptroller of the Currency has revised its "Concentrations of Credit" booklet, which is part of the *Comptroller's Handbook*. You can obtain the booklet, which provides updated guidance and examination procedures, at occ.treas.gov under "Publications." ▲

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.

P&G's uniqueness is characterized by its experienced staff and partners. Their hands-on involvement on each engagement provides our clients with a wide range of skills, experience and industry expertise. We employ the 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.

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.

For **Solutions** *to your internal audit needs, please contact our service coordinators at (877) 651-1700, or log-on to www.pandgassociates.com to learn more.*

www.pandgassociates.com

Headquarters:
646 US Highway 18
East Brunswick, NJ 08816

Offices:
New York, NY
Philadelphia, PA
Chicago, IL
Miami, FL