P&G Banking ADVISOR

Summer 2013

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Community banks: Prepare for an M&A surge

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Community banks: Prepare for an M&A surge

The confluence of several factors — including a struggling economy, intense competition and a challenging regulatory environment — is putting pressure on community banks to consider mergers and acquisitions (M&As) as a growth strategy. Each bank is different, so there's no single right answer to the question of whether to buy, sell or remain independent. But one thing is certain: Many bank directors will be asking themselves this question in the coming months.

Expected consolidation in the sector doesn't mean that community banks are on the verge of extinction. On the contrary, a recent FDIC study observed that "community banks continue to play a unique and important role in our economy." But the study suggests that small community banks might consider mergers to remain viable. (See "FDIC *Community Banking Study*" on page 3.)

If your bank is exploring M&A opportunities, you'll need to consider a number of issues as you go through the merger or acquisition process.

Getting a valuation

It's important to obtain an independent, professional valuation of your bank. If you're selling, it helps ensure that you receive a fair price and protects the board against claims that it failed to act in the shareholders' best interests.

> Execute confidentiality and nonsolicitation agreements to prevent the other party from disclosing or using sensitive information learned in the due diligence process.

If you're buying, a valuation of the target helps ensure that you don't overpay. It's also important to conduct a valuation of your bank, particularly if all or part of the purchase price will be paid with the bank's stock. Valuing your bank also helps you evaluate the transaction's potential impact on its capital.

In certain situations it's a good idea to obtain a fairness opinion — that is, a statement by a financial professional that a proposed transaction's terms are fair to the bank's shareholders from a financial perspective.

Structuring the transaction

Generally, community banks prefer mergers over asset or stock acquisitions, for two reasons. First, if properly structured, a merger can be tax-free to the seller's shareholders. And second, a merger allows the buyer to acquire all of the seller's stock upon approval by the seller's shareholders (typically, by a two-thirds vote).

Asset purchases are relatively uncommon because they usually result in substantial tax liabilities for the seller. But in some cases, they're desirable. For example, a buyer may be unwilling to assume certain seller liabilities. Unlike a merger, in which the buyer assumes *all* of the seller's liabilities, an asset purchase gives the parties some flexibility when determining which liabilities the buyer will assume.

From the buyer's perspective, there may be tax advantages to an asset purchase. For sales where a premium is paid, it gives the buyer a stepped-up basis in the assets, which will reduce the capital gains on assets that are later sold. In some cases, including certain sales of S corporation banks, a buyer may be willing to pay a higher purchase price in exchange for these advantages.

Performing due diligence

During the due diligence process the buyer should examine a variety of financial, operational and compliance items, with emphasis on the quality of the target's loans and deposits, and the transaction's impact on regulatory capital. For the seller, due diligence is usually less extensive, but still important, especially if the seller is receiving the buyer's stock as payment.

You should execute confidentiality and nonsolicitation agreements to prevent the other party from disclosing or using sensitive information learned in the due diligence process or from raiding your employees in the event the deal falls through.

Dealing with uncertainty

One of the biggest challenges in negotiating an M&A transaction is reconciling the parties' conflicting views on the target's value. In many cases, for example, the seller has a more optimistic view about its projected earnings or the collectibility of loans. One potential solution used to reconcile differences of opinion on value is an "earnout" provision in the purchase agreement. An earnout makes a portion of the purchase price contingent on future events, such as achievement of a specified level of earnings, collection of certain loans or settling a litigation matter.

Handling with care

These are just a few of the many factors to consider when contemplating M&A opportunities. Other issues include negotiating the purchase agreement, obtaining regulatory approval, and dealing with employee compensation and benefits issues. Experienced financial and legal advisors can help you navigate this complex process. ▲

FDIC *Community Banking Study*

In December, the FDIC published its *Community Banking Study*, a "data-driven effort to identify and explore issues and questions about community banks." Among other things, the study examined industry consolidation from 1984 to 2011 to determine whether that consolidation was related to economies of scale, which placed smaller banks at a competitive disadvantage.

The study suggests that small community banks can reduce their costs and enhance their viability through growth. But the FDIC concluded that most of the benefit from economies of scale is realized once a bank reaches $100 million to $300 million in total assets, depending on its lending specialty. This conclusion is supported by data from the study period, during which the number of banks with assets of less than $25 million declined by 96%, while the number of banks in the $100 million to $10 billion range increased by 19%.

Accounting for credit losses

Getting ready for big changes

For community banks, accounting for credit losses — which are reflected in the allowance for loan and lease losses (ALLL) — is a critical process that can have a significant impact on earnings and capital. Recently, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) proposed to change the way financial institutions determine when and how credit losses should be recognized.

At press time, both boards were reviewing comments to their respective proposals. Hopefully, they will issue a "converged" standard later this year.

A forward-looking approach

Many people believe that the 2008 financial crisis was caused, at least in part, by weaknesses in the way banks and other companies report credit losses. Under current standards, banks use an "incurred loss" model to account for credit losses on loans and other financial instruments.

FASB's proposals are designed to require more timely recognition of credit losses while providing added transparency about credit risk.

In other words, a bank doesn't recognize a credit loss until it's determined that a "loss event" makes it probable that a loss has taken place. To make this determination, banks examine historical events as well as current conditions, but they need not take into account forecasts that affect expected collectibility in the future.

FASB and the IASB fear that this approach causes losses to be reported too late in the credit cycle. The board's proposals, thus, are designed to require more timely recognition of credit losses while providing added transparency about credit risk. To accomplish this goal, the proposals replace the incurred loss model with an "expected loss" model.

According to FASB's March 25 FAQ, its proposal would require "an allowance for credit losses at a present value, based on *contractual cash flows not expected to be collected ….*" Banks would be required to consider a broader range of information, including 1) historical loss information on similar assets with similar credit ratings, 2) current conditions, and 3) reasonable and supportable forecasts about future events that affect expected cash flow collections.

Differences between the proposals

The IASB also advocates an expected loss model, but with a significant difference: Under its proposal, a bank would recognize only a portion of expected loan losses (for one year following the reporting date) unless there's been "significant credit deterioration" since origination of the loan, in which case it would recognize "lifetime expected credit losses."

According to FAQ 19, FASB rejected a similar approach, concluding that a "credit deterioration" model is akin to an *incurred* loss approach rather than an *expected* loss approach.

The next steps

It remains to be seen whether FASB and the IASB can resolve their differences and arrive at a converged standard for accounting for credit losses. Although the details still need to be worked out, it seems clear that banks will soon be required to adopt an expected loss model for computing their ALLL.

The final standards likely won't take effect until late 2014, but consider beginning preparations now. Ensure that your bank has policies and procedures in place to estimate expected losses and to evaluate the potential impact of the new standards on your financial statements. ▲

What do you know about ESOPs?

Unless bankers have participated in a qualified retirement plan that invests in employer stock early in one's career, many know little about employee stock ownership plans (ESOPs). Here's some information about ESOPs to add to your knowledge base.

ESOPs invest in the bank's stock

An ESOP is a qualified retirement plan that invests in the bank's own stock. The bank can contribute stock to the plan or it can contribute cash used to acquire bank stock, which is allocated to employees' accounts. In a leveraged ESOP, the plan acquires a large block of shares from the bank or its shareholders by borrowing money from another bank, usually at favorable rates.

As with other qualified plans, your bank's contributions to the ESOP are tax deductible (generally up to 25% of eligible participants' compensation). In addition, ESOPs must comply with specific rules and regulations, including strict nondiscrimination requirements. Closely held banks must have their stock valued by a qualified, independent appraiser when it establishes the ESOP and annually thereafter.

When ESOP participants retire, die, become disabled or terminate their employment, their benefits are distributed as stock or cash. Closely held banks are required to give employees a "put option" — that is, the right to sell the stock back to the bank at its current fair market value. Some banks limit stock ownership in the corporation so that participants must sell their stock to the bank or the plan at distribution. These options can generate significant "repurchase liabilities" that your bank should plan for and monitor.

Equity attracts employees

Equity is a powerful incentive you can use to attract, retain and motivate employees. Sharing ownership with employees through an ESOP also ties them to your community bank and aligns their interests with your objectives and strategies. As your bank grows and its stock value increases, employees share in the success.

Another advantage of an ESOP is that your bank can spread the wealth in a tax-advantaged manner.

Earnings and appreciation on stock held by an ESOP are tax-exempt, so employees' accounts grow on a tax-deferred basis. Participants recognize taxable income only when they withdraw their benefits from the plan. Distributions are taxed the same as 401(k) plans and other qualified plans, including a penalty for withdrawals before age 59½, with certain exceptions. Additionally, like a 401(k), distributions from the ESOP must begin in the year the employee reaches age 70½.

The bank and owners also benefit

An ESOP provides several benefits for your community bank and its owners. For example, the bank's ESOP contributions are tax deductible (up to applicable contribution limits) and, under certain circumstances, it can deduct dividends paid on ESOP shares.

Also, a leveraged ESOP can be a highly tax-efficient vehicle for raising capital. Ordinarily, only interest is deductible on a business loan. But your bank can make tax-deductible contributions to a leveraged ESOP to cover both interest and principal payments.

For closely held banks, an important benefit of an ESOP is that it creates a market for the existing owners' stock without necessitating a sale to "outsiders." By selling a portion of the business to an ESOP, the owners can generate income or diversify their portfolios while retaining control of the bank.

ESOPs offer some remarkable opportunities for banks organized as S corporations. For example, being tax-exempt, an ESOP wouldn't pay tax on the S corporation's profits.

And if the ESOP owns at least 30% of a C corporation bank's stock immediately after the sale, the owners can defer their capital gains indefinitely by reinvesting the proceeds in qualified replacement property (QRP) within one year. QRP includes most stocks and bonds issued by publicly traded domestic operating companies.

Pros and cons for S and C corporations

ESOPs offer some remarkable opportunities for banks organized as S corporations. Notably, as pass-through entities, S corporations pay no entity-level taxes. Instead, shareholders report their share of the corporation's profits, losses and other tax attributes on their personal income tax returns. Being tax-exempt, an ESOP wouldn't pay tax on the S corporation's profits.

One significant disadvantage for S corporations (over their C corporation counterparts) is that owners can't defer the gain on the sale of their stock to an S corporation ESOP. Additionally, the contribution limit to an S corporation ESOP is 25% of compensation for both principal and interest. There are a plethora of other considerations for both S and C corporations, which will require the advice of your bank's financial and tax advisors. ▲

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STUDY LINKS HIGHER CRE CONCENTRATIONS WITH BANK FAILURE

The Federal Reserve and the OCC recently published a joint white paper that analyzes the impact of the OCC's 2006 commercial real estate (CRE) concentration guidance. That guidance urged banks to implement enhanced credit risk controls if:

1. Construction, land and land development loans represent 100% or more of total risk-based capital, or
2. Total CRE loans represent 300% or more of total risk-based capital *and* the outstanding balance of their CRE loan portfolio has increased by 50% or more during the previous three years.

According to the white paper, banks that exceeded these criteria were far more likely to fail. For example, 13% of banks that exceeded the first concentration level and 23% of banks that exceeded both levels failed during the 2008-2011 downturn, compared to 0.5% of banks that stayed at or under the recommended levels. ▲

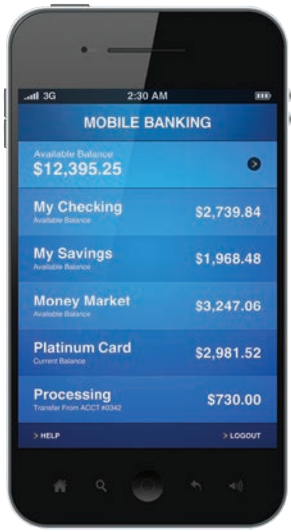
ACCOUNT-OPENING BONUSES: HANDLE WITH CARE

Banks sometimes offer account-opening bonuses to customers as an incentive to save. In a recent private letter ruling (201340043), the IRS addressed the issue of whether a financial institution has a tax-reporting obligation with respect to bonuses for new IRAs or Section 529 college savings plans.

The IRS concluded that bonuses credited to IRAs are similar to payments of interest or dividends. Therefore, the institution in question had no tax-reporting obligation with respect to them. But bonuses credited to Sec. 529 plans, which are established and maintained by the *state*, are more akin to third-party contributions. As such, they are income to the account owner and reportable by the institution to the extent that reportable payments total $600 or more. ▲

MOBILE BANKING SHOWS SWIFT RISE

In March 2013, the Federal Reserve Board published a report entitled *Consumers and Mobile Financial Services 2013*. Based on a November 2012 survey, the report indicates that consumer use of mobile financial services has grown since the Fed's previous survey in December 2011. For example, 28% of all mobile phone users and 48% of all smartphone users reported using mobile banking in the preceding 12 months, up from 21% and 42%, respectively, in the earlier survey. ▲



MORTGAGE RULE COMPLIANCE GUIDE

The Consumer Financial Protection Bureau has published a guide designed to help smaller lenders implement the "Ability-to-Repay and Qualified Mortgage Rule," adopted in January, which requires mortgage lenders to make a reasonable, good-faith determination of a borrower's ability to repay a loan. Lenders that offer "qualified mortgages" are presumed to be in compliance. You can find a link to the guide by visiting consumerfinance.gov and typing "Small Entity" in the search box. ▲

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.

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.

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