P&G Banking ADVISOR

Winter 2014

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An e-sign of things to come
Are you ready for electronic signatures?

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Lessons from thriving banks: It's a real-world stress test

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Lessons from thriving banks: It's a real-world stress test

Bank failures during the recent recession led some people to question the ongoing role of community banks in our nation's financial system. But a recent report by the Federal Reserve Bank of St. Louis (the "St. Louis Fed") suggests that community banks will continue to play a vital role in the U.S. economy by "allocating credit and providing financial services in their communities — particularly to the small businesses in those communities."

The report, "The Future of Community Banks: Lessons from Banks That Thrived During the Recent Financial Crisis," analyzes distinguishing features of banks that thrived during the recession. The authors concluded that community banks can prosper in the future by maintaining strong risk management standards in all economic environments and tailoring their business plans to their markets.

More banks thrived than failed

The St. Louis Fed examined the performance of community banks with less than $10 billion in total assets from the beginning of 2006 through 2011. During that period, 417 banks and thrifts failed. (Another 51 banks failed in 2012.) At the same time, 702 community banks "thrived" — defined as maintaining a composite CAMELS rating of 1 during the study period.

To identify the characteristics that distinguished thriving banks from those that merely survived, the report's authors analyzed balance sheet and income statement ratios. They also conducted detailed interviews with the leaders of 28 thriving banks.

Highlights of the findings

The thriving banks were located in 40 of the 50 states. Compared with surviving banks, thriving banks tended to be:

- Smaller (a higher percentage had less than $100 million in assets, although the authors don't believe that staying within a certain size range is the "secret" to thriving),
- More rural,
- Less "loaned up" — that is, they had lower ratios of total loans to total assets,
- Less concentrated in commercial real estate loans,
- Significantly less concentrated in construction and land development loans,
- Slightly more concentrated in one- to four-family property mortgages,
- Slightly less concentrated in commercial and industrial loans,

- More concentrated in agricultural and consumer loans, and
- More reliant on core deposits.

In general, thriving banks outperformed surviving banks in several areas, including return on assets, return on equity, loan losses to total loans, and efficiency ratio. They emphasize non-interest income and tend to have lower ratios of loans to assets and higher ratios of core deposits to total deposits. (See "Key performance indicators" at right.)

Key performance indicators

According to a recent study by the Federal Reserve Bank of St. Louis (see main article), thriving banks received better scores than surviving banks on several key performance indicators. Here's a sampling of the Fed's findings:

Attribute	**Thriving banks**	**Surviving banks**
Return on assets	1.5%	0.8%
Return on equity	12.7	7.3
Loan losses / total loans	0.1	0.5
Provision expense / average assets	0.1	0.4
Efficiency ratio	61.1	71.8
Net noninterest margin	1.9	2.3
Total loans / total assets	54.4	65.0
Core deposits / total deposits	83.0	80.7

Source: Federal Reserve Bank of St. Louis

The study also indicated that thriving banks tend to adopt relatively conservative growth strategies during good times, enabling them to capitalize on their competitors' mistakes during bad times. In the period leading up to the recession, for example, surviving banks enjoyed significantly higher asset growth than thriving banks (44.28% vs. 23.58%). But after the financial crisis hit, growth among surviving banks plunged to 26.91% while growth among thriving banks *increased* to 31.16%.

The authors acknowledge that agricultural loans performed relatively well during the study period, but that could change in the future. To limit the influence of these loans on their analysis, they examined various attributes separately for urban banks and for rural non-agricultural banks. They found that, for these groups, as for community banks as a whole, the same set of factors appears to correlate with long-term financial health.

The authors note that the local economy can have a big impact on performance. At the same time, a number of community banks thrived in states that experienced the greatest decline in real gross domestic product (GDP) during the study period, and a number of banks failed or received CAMELS ratings of 4 or 5 despite being in states that experienced significant GDP growth.

Insights from bank leaders

Interviews with leaders of thriving banks reveal several important themes. They all embrace conservative loan principles, including limiting lending to their own communities, avoiding opportunities outside their expertise and maintaining strong underwriting standards. Many of these banks also maintained high allowances for loan and lease losses.

They also emphasized strong risk management controls, in some cases sacrificing income in exchange for lower risk exposure. That's why many of the thriving banks prospered despite high concentrations of CRE assets.

One size does not fit all

The St. Louis Fed report provides valuable guidance on the factors that distinguish thriving banks from those that merely survive. But each bank also needs to consider its individual circumstances. One area where there was little uniformity among thriving banks was their business plans. These banks thrived in large part because they designed their business plans to fit their markets.

You can find the full report at research.stlouisfed.org. Click on "Publications / Review / Past Issues / 2013" and scroll down to the March/April issue. ▲

Psst … Is your client headed for divorce?

If some of your borrowers are headed for divorce court … take heed. Why? Because if a couple co-owns a company, it might place the loan at risk. Here are some issues you should consider if a client is preparing for divorce court.

A one-man show

Sometimes one spouse controls the business, and the other spouse pursues outside interests. A key question in these cases is how much of the private business interest to include in the marital estate. The answer is a function of purchase date, prenuptial agreements, length of marriage, legal precedent and state law.

Goodwill is another point of contention. If a business has value beyond its tangible net worth, how is intangible "goodwill" split up? All goodwill is included in (or excluded from) the marital estate in some states. But about half the states divide goodwill into two pieces: business goodwill and personal goodwill. The latter is excluded from value in these states.

Accurate valuations and reasonable payout periods are important. Settlements that disproportionately favor the noncontrolling spouse can drain company resources and cause financial distress. If the parties can't reach an equitable settlement, it's also possible for the court to mandate a liquidation, which threatens business continuity.

Even if your business borrowers aren't currently contemplating divorce, consider what might happen if they did.

When the company buys out a spouse, Treasury stock might appear on the balance sheet. Or you might see an increase in shareholder loans if the owner-spouse borrows money from the business to pay divorce settlement obligations.

The matter of maintenance payments

The noncontrolling (or nonmonied) spouse also may receive alimony and child support from the controlling shareholder. Maintenance payments typically are based on the owner's annual salary, bonus and perks.

Unscrupulous owner-spouses may try to change compensation levels in anticipation of divorce. Depending on the type of entity they own, a lower wage level may benefit them in negotiations for spousal maintenance and child support.

Also be aware that what divorcing borrowers say on the stand about unreported revenues, below-market compensation and personal expenses run through the business could lead to negative tax consequences.

Publicly admitting these tax avoidance strategies puts both spouses *and* the business at risk for IRS inquiry.

The loss of a key person

Many private businesses are run by both spouses, whose complementary skill sets make for a hard decision: Who's going to run the business after the divorce? In limited cases, the spouses may want to continue to run the business together. Like most stakeholders, if co-owners decide to split up personally, but maintain their professional relationships and continue comanaging the business, you may be rightfully skeptical. Usually, however, the parties can't imagine working with each other. Such a scenario requires a buyout and a noncompete agreement.

Buyouts should occur over a reasonable time period and can include an earnout — wherein a portion of the selling price is contingent on future earnings — to avoid undue strain on the business. Future success is uncertain when a business loses a key person. It's fair for both shareholders to bear that risk. If they don't, the remaining owner, and your bank, could be at risk.

Even if your ma-and-pa business borrowers aren't currently contemplating divorce, consider what might happen if they did. Proactive family businesses have a buy-sell agreement in place *before* personal relationships sour. Factors to consider include valuation formulas and methods, valuation discounts, earnout schedules, post-buyout consulting contracts, noncompete agreements and payment of appraisal fees.

A sticky situation

Divorce can truly ruin lives and a couple's livelihood. And as a lender, you might be concerned that you'll lose a valued client in the process. The good news is that you can always recommend a financial advisor to help divorcing couples, or your bank itself may provide such services. Either way, you'll likely protect the loans from default and delays. ▲

An e-sign of things to come

Are you ready for electronic signatures?

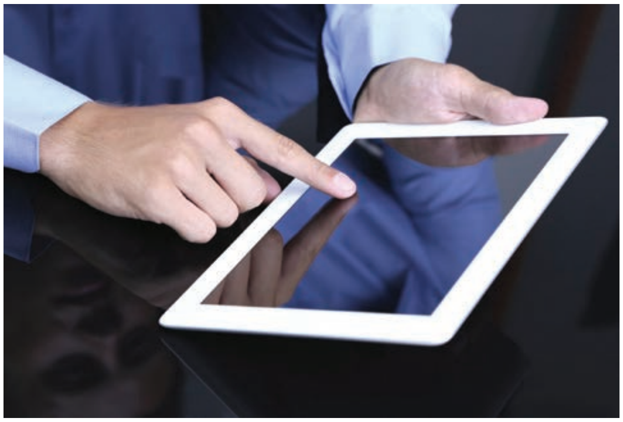
As the world continues its journey to going paperless, an increasing number of banks are adopting electronic signature technology for new account openings, loans, disclosures and other transactions.

Interest in electronic signatures is driven by customers. They enjoy the convenience of doing business on a variety of devices, without having to go to a bank branch to sign documents or wait for "snail mail." In addition to enhancing customer satisfaction, the technology offers significant benefits for banks.

Many advantages

From a bank's perspective, electronic signatures offer the cost savings that come with eliminating paper as well as the ability to close transactions more quickly. The end result? Your bank can improve revenue turnaround and cash flow.

Electronic signature systems can also reduce errors. For example, a good electronic signature system won't allow customers to submit documents until they've signed or initialed them wherever required. And automating the process ensures that the parties are reading the documents' latest versions.



Electronic signature systems also can enhance compliance. They make it easier and faster for customers to sign off on required disclosures and will alert the bank if documents are missing.

Legal requirements

Electronic signatures are governed at the federal level by the Electronic Signatures in Global and National Commerce Act (ESIGN) and, in most states, the Uniform Electronic Transactions Act (UETA). (The few states that haven't adopted the UETA have their own electronic signature laws.)

ESIGN defines electronic signature as an "electronic sound, symbol or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record." Customers might click an "I agree" button, type their names or passwords, or take some other action to indicate their intent to sign.

Generally, in order for electronic signatures to have the legal weight of a traditional ink signature, the parties must agree to use electronic records in lieu of paper. ESIGN and many states' laws require banks to provide a consumer with certain disclosures and to receive the consumer's written consent. The consumer should consent, or confirm consent, electronically using a method that demonstrates his or her ability to access and sign electronic records.

Integrate electronic signature solutions with your existing websites, customer portals and applications.

Best practices

Dozens of vendors offer electronic signature solutions that comply with the letter of the law. But to ensure that electronic signatures hold up in court, your system should incorporate certain best practices, such as:

- Requiring users to establish their identities with strong authentication methods (for example, username and password plus a passcode sent via text message) before electronically signing a document,
- Using secure encryption to prevent unauthorized access to electronic records,
- Creating a detailed audit trail, including time stamps, of each step in the signature process (ideally, showing what the user saw and what actions he or she took every step of the way),
- Ensuring that the signature is permanently linked to the document being signed,
- Affixing a "tamper-proof seal" to documents, so they can't be altered after they're signed, and
- Requiring users to sign or "initial" every required line before submitting a signed document.

To ensure customers are comfortable with the process, integrate electronic signature solutions with your existing websites, customer portals and applications. A familiar user interface will help build trust in the system.

Testing the waters

If you're considering an electronic signature system, there's no need to implement it all at once for every process or document. Consider running a "pilot program" before rolling it out throughout the organization.

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TAKE AN INTEREST IN INTEREST RATE RISK

In a recent Financial Institution Letter (FIL-46-2013), the FDIC signaled a heightened interest in banks' interest rate risk management practices. The agency is concerned that many banks aren't "sufficiently prepared or positioned for sustained increases in, or volatility of, interest rates." As a result, in a rising interest rate environment, institutions with a "decidedly liability-sensitive position" could experience

declines in net interest income, deposit run-off, deposits and rate-sensitive liabilities that reprice more quickly than earning assets, and other issues.

The FDIC strongly urges bank boards and management to analyze on- and off-balance-sheet exposure to interest rate volatility and take appropriate steps to mitigate the risk. Examples include rebalancing earning asset and liability durations, proactively managing nonmaturity deposits, increasing capital, and hedging.

You can read the FIL at FDIC.gov; click on "News & Events" and "Financial Institution Letters" to reach the link. ▲

EDUCATE CUSTOMERS ABOUT FRAUD PREVENTION

Historically, when bank customers are victimized by wire transfer fraud, the *bank* has been liable for the loss. But in a March 2013 case, a federal court ruled that the liability shifted to a *customer* that opted out of security measures offered by the bank.

In *Choice Escrow and Land Title, LLC v. BancorpSouth Bank*, a business customer sued its bank after fraudsters used an employee's user ID and password to make a $440,000 wire transfer out of the customer's account using the bank's Internet-based wire transfer system.

The customer declined to use dual controls — which required two individuals with separate user IDs and passwords to enter and approve transfers — because it frequently had only one employee working at a time.

By offering commercially reasonable security procedures and documenting the customer's waiver of those procedures, the bank protected its interests, but it likely lost a customer. The bank could have protected itself *and* customers by educating them about the need for security procedures, discussing the reasons for waiving the procedures, and exploring potential alternatives. In this case, additional authentication procedures, such as hardware tokens or passcodes sent by text message, might have prevented the fraud. ▲

ELDER FINANCIAL ABUSE MAY NOW BE REPORTED

The Gramm-Leach-Bliley Act generally prohibits financial institutions from providing consumers' nonpublic personal information to third parties

without first notifying consumers and giving them an opportunity to opt out. But in recent joint guidance, seven federal regulators — including the SEC, CFPB, FDIC, OCC and Federal Reserve Board — clarified that it's generally acceptable to report suspected elder financial abuse to the appropriate authorities. ▲

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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