Community Bank Director

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REGULATION

Safety and Soundness Exam—the "A" in CAMELS

The term asset quality refers to the degree of financial strength and risk associated with a bank's assets, primarily loans and investments. The bank's safety and soundness examination includes an evaluation of asset quality—a very important component in assessing the bank's current condition and future viability.

One of the primary objectives of the safety and soundness examination is to determine whether borrowers will repay their loans when the obligations are due. As we have witnessed recently, poor asset quality can suggest that there may be potential problems for management, customers, shareholders and regulators.

It can also be an indication of future charge-offs. From an examiner's perspective, this indicator helps to identify poor managers and potential problem banks. In turn, this asset quality measure may have a negative affect on a bank's earnings, capital and liquidity.

Classified credits have a negative impact on earnings through reduced interest income, a higher required provision for loan and lease loss reserves, and the higher administrative costs needed to manage those accounts. Poor asset quality also reflects negatively on management's competence.

For this reason, it's very important to have established policies in place that specify the board's credit risk tolerance, in addition to collection and work-out directions that mitigate losses. Equally as important are procedures to monitor the bank management's compliance with those policies.

Although credit risk exposure usually refers to loans, this category also includes investments, items due from banks, other real estate owned (OREO), suspense accounts, cash items not in the process of collection, off-balance-sheet items like letters of credit, and unfunded loan commitments—just to name a few.

Bank loan grading systems put in place at a loan's inception allow the bank to mitigate the risk by charging higher interest rates or requiring additional collateral—depending on the bank's tolerance for risk. The loan review process, performed either internally or by a third-party vendor, is an assessment of the bank's loan portfolio risk. This process typically would validate the risk grade assigned.

Banks should adjust a loan's risk grade as soon as they become aware of any changes in a borrower's ability to repay a debt, whether the change is due to a payment delinquency or an economic downturn that directly and negatively impacts the bank's borrower or the loan's collateral.

Although asset quality has been covered in prior articles, board members' responsibilities in this area cannot be stressed enough. Board members must regularly review past-due reports, large overdrafts and loan review reports so that they may be aware of any changes in asset quality.

The other categories covered by the safety and soundness section of the regulatory exam are typically handled by management, but audit reports should keep board members abreast of any potential irreconcilable charge-offs to general ledger accounts. ■

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Internet Gambling Final Rule Released

The Treasury Department and Federal Reserve Board announced a joint final rule, *Prohibition of Funding of Unlawful Internet Gambling* (Regulation GG), to implement the Unlawful Internet Gambling Enforcement Act of 2006. The act prohibits gambling businesses from knowingly accepting payments in connection with unlawful Internet gambling, including payments made through credit cards, electronic funds transfers and checks.

Although ICBA opposed the Internet Gambling Enforcement Act of 2006 because it placed a burden of identifying and blocking unlawful Internet gambling payment transactions on the banking industry and payment systems, ICBA believes the final rule lessens the act's potential burdens.

Under the proposal, due diligence policies and procedures generally:

1.) Require screening of potential commercial customers to ascertain the nature of their business;

2.) Prohibit customers from engaging in restricted transactions; and

3.) Require screening of card transactions that use a merchant and transaction coding framework that permits participants to identify and block restricted transactions.

The final rule also provides additional guidance on due diligence steps participants can take for commercial customers to have reasonably designed policies and procedures to prevent or prohibit restricted transactions. It does not include periodic confirmation of the nature of customers' business, which ICBA opposes and believes that such a requirement would impose a considerably greater burden on participants without commensurate benefit to enforcement.

The final rule does not include a prohibited list of unlawful Internet gambling businesses. In a December 2007 comment letter, ICBA stated that "the creation and ongoing maintenance of such a list is not feasible given the significant initial and ongoing burden and cost."

Finally, the rule does not define "unlawful Internet gambling" beyond the act's definition. ICBA recognizes the ambiguity in the proposed rule, particularly with regard to what constitutes "unlawful Internet gambling" is due to the ambiguity in the law.

ICBA to SEC: Fair Value Accounting Unfair for Community Banks

ICBA told the Securities and Exchange Commission (SEC) in a comment letter that full mark-to-market, or fair value, accounting is inappropriate for community bank financial statements and current standards have exacerbated the current financial crisis. In the comments, on an SEC study required by the Emergency Economic Stabilization Act of 2008, ICBA said accounting measures should more closely reflect the way financial instruments generate earnings and cash flows. It told the agency that more implementation guidance is needed.

Current Environment—While supporting sound financial reporting policies, ICBA raised community banker concerns that fair value accounting has exacerbated the recent financial crisis as financial instruments are priced not at "fair value," but at forced liquidation values, despite current guidance.

In many cases, markets have not been orderly, yet values have been determined based on their activity or, more likely, inactivity. Fair values of financial instruments have been determined where no buyers are in the market or at "fire sale" levels, which is particularly troubling for financial institutions whose capital position—and continued survival—depends on these valuations.

Also, community banks have complained to ICBA about needing to write down to "fair value" assets based collateral values where a cash flow analysis provides a very different picture. In such cases, collateral values have fallen significantly, yet the asset performs and is expected to continue to perform according to agreements. Many community bankers believe that auditors and examiners are being overly cautious in recommending aggressive "fair value" write downs, exacerbating the current credit crisis.

Revisiting Allowance Guidance—The SEC and FASB should work with banking regulators to review current loan-loss allowance guidance to determine if it is truly appropriate for long-term economic health, ICBA stated. Current standards provide little ability for financial institutions to set aside reserves in good times to prepare for bad times due to concerns about the management of earnings.

Accounting Standard Convergence—ICBA also noted that converging to international standards can disadvantage smaller financial institutions and businesses. Users of these businesses' financial statements generally will not need the level of complexity of those created for large international companies. In addition, complex standards are often much more difficult and burdensome for smaller institutions to implement, with implementation costs far outweighing the benefits.

Addressing Technology Strategic Planning

How a financial institution uses information technology (IT) can greatly affect its financial condition and operating performance—and even potentially its safety and soundness. With banks' increasing dependency on information technology, regulators expect an organization's management and board of directors to manage the risks associated with IT effectively.

Not that long ago in the banking industry, information technology was limited to the automation of routine transactions and the preparation of financial reports. Now IT is used to automate all levels of a banking organization's operations and information processing.

Some decision-making processes, such as credit scoring and securities trading, have been fully automated. New, complex financial products can be offered largely because financial institutions can now access and use valuation models made possible by today's technology. Moreover, technological advances in communications and connectivity have loosened geographic constraints. Banks can operate effectively and efficiently over large geographic areas in real time.

It's common for banks to have annual strategic planning sessions—more and more often, they are conducted off-site to allow the management and the board a day or two of uninterrupted time to think about the company's direction. And more often than not, the decisions being made at these sessions will include whether to make a significant purchase or investment in a new office, new software or hardware, etc.

Strategic IT planning focuses on a three- to five-year horizon, which helps to ensure that the bank's technology plans are consistent with the bank's strategic plans. To achieve this consistency, it is best to include a member of the IT department in the strategic planning sessions. If done effectively, strategic IT planning can deliver IT services that balance cost and efficiency while enabling the bank to meet the competitive demands of its market.

Strategic planning should address long-term goals and the allocation of IT resources to achieve those goals. Tactical plans should outline the specific steps and timetables needed to achieve the strategic goals. These plans should identify hardware and software needs, end-user computing resources and any processing done by outside vendors. The overall strategic plan should address the budget, periodic reporting to the board and the status of risk management controls.

The bank's board of directors and management should consider these and other relevant factors when planning for the acquisition and use of technology:

- Marketplace conditions;
- Customer demographics;
- Growth targets for the bank;
- Technology standards;
- Regulatory requirements for privacy, security and consumer disclosure;
- Cost containment;
- Process improvement and efficiency gains;
- Customer service and technology performance quality;
- Outsourcing versus using in-house expertise; and
- Ability of the bank to adopt and integrate new technology.

The technology decisions a bank makes, based upon the factors listed above, should align with the bank's business plans. Well-implemented technology plans provide ample return on investment in terms of the market share, earnings and capital growth of the organization.

Typically, when banks can keep their IT plans aligned with their changing business goals and objectives, they can compete more effectively in the marketplace.

Some banks spend too aggressively on technology that their business lines cannot then fully use or support. Or sometimes banks spend too little or delay investment in infrastructure or new products that would support their business lines, and then they cannot compete and maintain their market share and profits.

In addition, without a full understanding of the available technology, community banks can fail to update processes and products that would help them take advantage of productivity gains or increase revenues. To create an appropriate balance, banks should link their strategic and operational plans to the corresponding goals they have set for their IT and other departments.

Directors must oversee management's efforts to create and maintain an alignment between IT and corporate-wide strategies by:

- Confirming that IT strategic plans are aligned with the business strategy;
- Determining that IT performance supports the planned strategy;
- Ensuring that the IT department is delivering on time, within budget and to specification;
- Directing IT strategy to balance investments between systems that support current operations and systems that transform operations and enable business lines to grow and compete in new areas; and
- Focusing IT resource decisions on specific objectives such as entry into new markets, enhanced competitive positions, revenue growth, improved customer satisfaction or customer retention.

All of these responsibilities are likely covered in your bank's annual strategic plan, which is why it may make sense to include someone from your IT department at your bank's next annual strategic plan meeting.

INVESTMENT OVERSIGHT

Duties in Overseeing The Investment Committee

The role of the investment committee serves at a community bank may vary significantly depending on the individual institution's size, the risk tolerance and the investment knowledge base of the committee's members.

Because this committee is often relatively small, the membership would primarily consist of the bank's CEO, CFO, investment officer and one or two bank directors. Actions taken by an investment committee depend upon economic factors and the bank's loan and deposit forecasts. Therefore, some community banks will ask its asset-liability committee or risk management committee to take on responsibilities that otherwise might be assigned to a separate investment committee.

If there are two separate committees, they must work closely together and coordinate their objectives and activities.

Committee function—An investment committee is a standing committee that, depending on its exact responsibilities and the level of the bank's investment activities, may regularly meet only monthly or even quarterly. This committee may be largely advisory in nature, reporting to the full board for final authority.

If the committee is to have the authority to approve investments outside of the bank's standing policy, then the bank's directors may wish to require that such approval be contingent upon the unanimous consent of the nonmanagement directors or that nonmanagement directors constitute a majority of the investment committee members.

At the monthly board meeting, the full board should receive a report that shows the investment purchases and sales that have occurred since the last meeting as well as a list of the investments that will mature in the upcoming month. The bank's policy will determine if the board is required to ratify the monthly investment activity.

Committee's responsibility—The responsibilities of an investment committee include oversight of the bank's investment activities and portfolio, review of the bank's investment policy guidelines, the development of investment objectives and performance measurement standards, and the approval of investments outside of the bank's policy or investment officer limits. The committee members must act solely in the interests of the bank for the purpose of meeting the financial needs of the company.

The bank's CEO or CFO often is responsible for the bank's daily investment activity and portfolio. As in other areas of banking, whoever takes on this responsibility should follow the direction and guidelines provided by the bank's investment policy. The investment policy should clearly define what an acceptable investment is. This policy should indicate the maturity ranges and distribution as well as mix and size of portfolio investments that the bank considers acceptable. In addition, there should be provisions for exceptions.

Board's responsibility—It's important that directors take an active role in understanding the risks associated with the investment portfolio and be ultimately responsible for setting major policies and risk limits. The full board should adequately review and assess investment activities to establish reasonable risk limits. In addition, the full board should require the bank's management to demonstrate compliance with the limits set.

Auditors typically document management's adherence to bank policy as part of the bank's internal audit, the results of which would be included in the audit report to the board.

IN WASHINGTON

ICBA Recommends Changes to FDIC Liquidity Guarantee Program

ICBA applauded the FDIC's efforts to unlock the credit markets with its Temporary Liquidity Guarantee (TLG) Program and provided recommendations to improve the program in a comment letter. The program's Transaction Account Guarantee Program will enhance depositor confidence in community banks and benefit large depositors, ICBA wrote.

To improve community bank participation in the Debt Guarantee Program, ICBA recommended the FDIC:

- Expand coverage to include all transaction accounts—interest-bearing and non-interest-bearing—to level the playing field for FDIC insured accounts and money market mutual funds at too-big-to fail institutions.
- Provide a separate opt-out for overnight federal funds to give entities additional flexibility;
- Develop model disclosure language for financial institutions to use;
- Adopt a new guarantee cap for all Program participants based on an entity's total liabilities as of Sept. 30, 2008; and
- Implement a risk-based pricing model with fees ranging from under 10 basis points to no more than 50 basis points.

ICBA urged the FDIC to exclude bank holding companies with significant non-bank subsidiaries from participating in the TLGP, as the net costs of the program will be borne by insured depositories only. The association also urged the FDIC to require the largest banks to participate in the program.

Agencies Issue Tax Guidance On GSE Preferred Stock Losses

Treasury and the banking agencies issued additional ICBA-requested guidance further clarifying the scope of GSE preferred stock investments qualifying for the special tax fix and guidance on the proper treatment of these tax benefits.

Notably, the new Treasury guidance on qualifying tax losses, effective Oct. 29, includes a broad list of indirect investments in Fannie and Freddie preferred stock that qualify for the ordinary tax loss treatment. The guidance covers:

- The sale or exchange of qualified preferred stock by a partnership in which an applicable financial institution is a partner;
- The sale or exchange by an applicable financial institution of an interest in certain partnerships; distribution of qualified preferred stock by certain partnerships to a partner that is an applicable financial institution;
- The sale or exchange of qualified preferred stock by certain subsidiaries of applicable financial institutions; and
- The sale or exchange by a taxpayer of qualified preferred stock, the basis of which in the taxpayer's hands is determined by reference to the basis of that stock in the hands of the person who had transferred it to the taxpayer.

Fed Survey: Community Banks Better Positioned To Lend

Credit conditions continued to tighten during the third quarter, according to the Federal Reserve Board. The Fed's Senior Loan Officer Survey demonstrates that community banks may be bettered positioned to lend than the largest banks during these difficult times. According to the October 2008 Survey on Bank Lending Practices, approximately 80 percent of the largest banks and just 55 percent of smaller banks reported tighter residential real estate lending standards for prime borrowers.

Federal Reserve Banks Cut Check Processing Sites

The Federal Reserve Bank of Cleveland will serve as the single paper check-processing and adjustments site for the Federal Reserve System, and the Federal Reserve Bank of Atlanta will serve as the system's single electronic check processing site.

The change updates a June 2007 announcement that the Atlanta, Dallas, Philadelphia and Cleveland banks would serve as regional processing sites. The consolidation step is a reaction to steadily declining paper check volumes.

Survey on Risk Management Mindsets

A survey on operational risks by ICBA and Total Risk Solutions clearly shows how community bankers view the current state of corporate governance and operational risk management. In the survey, nearly three-quarters of the 203 community bankers polled said they think positively about risk management, and 65 percent consider risk management a sound business practice.

More than 80 percent of respondents said they believe they are managing their operational risk effectively, and 9 percent said risk management provides them with a strategic advantage. With regard to regulatory scrutiny, 80 percent of respondents say their examiners are focused on operational risk.

Small Businesses Are Leading Innovators

The Small Business Administration's Office of Advocacy released a study showing small businesses are the economy's leading innovators because they obtain many more patents per employee than larger firms. In addition, their patents outperform larger firms on a number of measurements, suggesting that small firm patents are generally more likely to be technologically important. The report analyzes a database of nearly 1,300 small and large technology firms and more than 1 million patent records between 2002 and 2006.

Small Business Advocate Launches Blog

The Small Business Administration launched a new blog focusing on regulatory issues, small business research, state regulatory activity and other issues. The new blog, called the *Small Business Watchdog*, posts articles under several categories and allows readers to submit comments. Find the *Small Business Watchdog* at http://weblog.sba.gov/blog-advo.

Fed Warns of Fraudulent Loan Scheme

The Federal Reserve Board issued an alert regarding questionable solicitations promising consumers access to personal loans through a nonexistent Federal Reserve lending program. Under the scheme, consumers are encouraged to deposit large sums of money into a bank account, under the guise of a security deposit, to receive the loan. Consumers with questions about solicitations they suspect are fraudulent are encouraged to visit the Fed's Consumer Help Center or call (888) 851-1920.

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By Martina Stofko Dowidchuk

One Bank's Problem May Be Another's Growth Opportunity

The current squeeze on profitability and the growing credit crunch have forced many financial institutions to postpone their market expansion plans and refocus their attention on controlling expenses and managing credit risk. While this change in priorities may be necessary for some banks that face serious asset-quality decline and deteriorating capital positions, most community banks can view the current economic environment as an opportunity to grow and open new branches.

Changing landscape, entry opportunities— A single market can profitably support a limited number of retail banking outlets. Over the past several years, on average six new branches were opened each day across the country. With aggressive branch expansion taking place in many communities, the intense competition has, in certain areas, saturated markets and limited the revenue potential of each additional branch.

As some financial institutions are now forced to reassess the effectiveness and efficiency of their existing branch networks, companies are pulling back or getting out the market. The challenging economic environment can make these banks less competitive and more willing to consider divesting themselves of current branches or future branch land holdings.

This new reality may create emerging growth opportunities in markets that may have previously been oversupplied with branches or in areas where branch sites were not available.

Fear factor, bank reputation—Reports of institutions' credit troubles, branch closures and possible sale make customers concerned and willing to consider other alternatives. People are becoming more diligent about selecting financial institutions that they believe are trustworthy and viable. The markets where the major competitors are vulnerable to the "fear factor" may offer new opportunities for other institutions to attract new customers, if they can position themselves as credible and stable banking alternatives.

New loan growth potential—Large mortgage bankers exiting the market have left consumers with fewer loan sources. At the same time, many consumers are facing rate resets on their mortgage loans and are looking to refinance. Responsible community banks that have the ability to leverage their local market knowledge are in a good position to generate additional loan growth without an increased credit risk.

Lower land costs and building costs— As the economy slows and as land sales and new construction have stalled, land prices and building costs are becoming more favorable relative to recent higher price levels. This makes many attractive branch locations less expensive and more feasible. The lower initial investment means banks can break even in less time, thus lowering the risk associated with expansion.

As the current economic environment changes, the competitive landscape may offer community banks new opportunities to increase market share in existing markets or gain entry into new markets. However, the best opportunities will be reserved for those banks that are better prepared to respond to specific market needs than their competitors.

In Conclusion

As the current economic environment changes, the competitive landscape may offer community banks new opportunities to increase market share in existing markets or gain entry into new markets. However, the best opportunities will be reserved for those community banks that are better prepared to respond to specific market needs than their competitors.

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