

90 Day Note

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“M” is for Management and Managing

By: Kenneth Koher, Senior Consultant

During the last three years, bank management has been called upon to pull the proverbial “rabbit from the hat” to identify and meet various challenges which have been unlike any the industry has witnessed in a generation of banking. Many if not all of these challenges require a growing degree of risk management. Also, many if not all of these challenges include the need to pull strength from all management resources, including the board of directors, bank executives, and other specialists...“M.” Some of these ever-present risk challenges involve credit risk, concentration risk, liquidity risk, regulatory and compliance risk, reputation risk, and product/service offerings risk.

Regarding concentration risk, bank management needs to develop an ability to control risks beyond the loan portfolio, including investments, liquidity facilities, and engaging in off-balance sheet activities. It is equally important to understand and manage the relationship between concentration risk and capital. The greater the concentration risk, the higher the capital levels required to support the risk taken. That said, there should be directional consistency between the two...the same basic thought process for the relationship between asset quality and the ALLL.

Financial institutions that have remained sound and well-managed throughout this period of time have one thing in common – continuing efforts to improve risk-identification and management strategies. Some of the common basic elements in successful organizations include appropriate governance (policies) and controls; risk identification and measurement; and a management team that persistently rises to the occasion in the way of increasing their skills, drawing from the bank’s talent pool, and utilizing its tools and third-party resources.

As a former community banker with over thirty years in the industry, I found the use of quality third-party resources to be invaluable and necessary in accomplishing many tasks at hand. Over the years, I have hired Young & Associates, Inc. to provide such services as asset liability modeling, loan review, compliance audit, fairness opinion, ALLL analysis, policy development, board training, strategic planning, and branch and de novo bank feasibility analyses. I also attended many seminars and webinars featuring a professional from Young & Associates. As a former client of the company, I am proud to be part of its team now. I hope you also see our company as a valuable resource both now and in the future. If you would like to contact me, please give me a call at 1.800.525.9775 or send an e-mail to kkoher@younginc.com. □

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Capital Market Commentary

*By: Stephen Clinton, President,
Capital Market Securities, Inc.*

Economic Overview

The U.S. economic recovery stumbled in the first quarter with GDP growth reported at only 1.8%, down from 3.1% for the fourth quarter. Inflation was estimated at 3.2% in April. Unemployment was reported at 9.1% in May as

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job growth was minimal in the month. Retail sales missed expectations for the first time since December. The U.S. auto industry suffered its first significant setback in more than 18 months as new car and truck sales declined 3.7% in May. Of special importance:

- The Federal Reserve continued to maintain an accommodative stance at its April 26th – April 27th meeting, holding its short-term interest rate target at nearly zero, which was set in December 2008 during the financial crisis.
- Oil prices continue to hover near \$100 a barrel.
- U.S. military involvement in Libya, Afghanistan, and Iraq continues to tap U.S. financial resources.
- The S&P/Case-Shiller National Home Price Index showed that prices nationwide fell 4.2% in the first quarter after declining 3.6% in the fourth quarter of 2010. The index had seen increases in 2009 and early 2010.
- Foreclosure activity continues to dominate the housing markets. From 2007 to 2010 there were 8.6 million foreclosures. It is estimated that there are another 2 million foreclosures currently being pursued.
- U.S. office space is recording a similar level of vacancy rates (16%) as was experienced in 2003. Meanwhile, malls and shopping centers are averaging a vacancy rate of 9.1%, the highest in 11 years. Strip centers have been especially hard hit.

Dodd-Frank and Other Bank Regulation Update

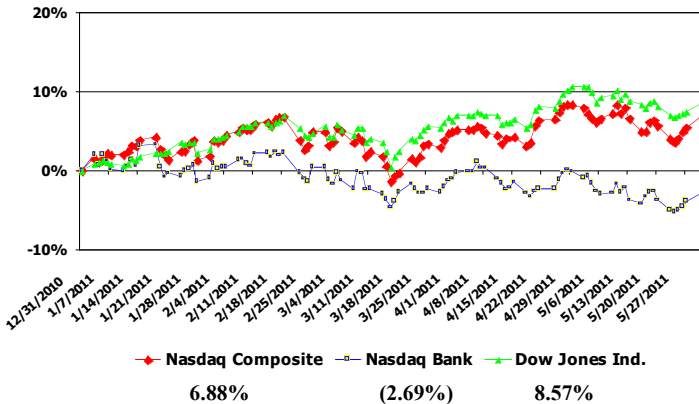
As we mentioned in our last newsletter, bankers should be carefully monitoring current events surrounding the massive financial overhaul law. Recent items in the news include:



- Durbin Amendment – The Dodd-Frank bill included an amendment to have the Federal Reserve cap debit card fees paid by vendors. The Fed has proposed to limit swipe fees at \$.12 per debit card transaction, a significant reduction from the current average of \$.44. While the Fed has not completed a comprehensive study on its proposal as required by Dodd-Frank, unless Congress takes action, the Fed proposal is scheduled to take effect in July.
- Risk Retention – The Dodd-Frank bill requires banks to hold 5% of the credit risk for mortgages and other loans that are bundled together and sold off as securities. The goal of the risk retention requirement was to have parties conducting securitizations have “skin in the game.” The law provided an exemption for certain “qualifying” loans but left to bank regulators the determination of what would be considered a “qualifying” loan. A draft of risk retention rules has been released and many found the definition to be more narrow than expected. The concern is that borrowing costs are likely to rise for loans that are subject to risk retention requirements because of the higher capitalization that will be required by parties that securitize such loans. There is also a concern that the risk retention rules may change the nature of loan products available, which could further dampen the weak housing market.
- Brokered Deposits – Dodd-Frank also requires the FDIC to conduct a study on core and brokered deposits, evaluating the definitions and looking at issues from how they affect deposit insurance premiums to the potential impact of reforms. The regulatory definition of brokered deposits was developed in the 1980’s. Since then, the market has changed significantly. The growing use of internet-generated deposits and CDARS deposits are expected to be considered as the FDIC conducts its study. Many community banks could be impacted should these funding sources be considered brokered deposits as a result of the FDIC study.
- GSE Reform – The government took over Freddie Mac and Fannie Mae in 2008. Since the take over, the two GSEs have cost taxpayers \$134 billion.

The Obama administration outlined three options in February to change the way home loans are financed, calling for the slow death of mortgage giants Fannie Mae and Freddie Mac and jumpstarting the debate over the future role of government in helping borrowers secure mortgages. Recently, House Republicans introduced eight separate bills that were all related to limiting the activities of the GSEs.

Price History – Nasdaq Bank Index Compared to General Market Indexes



Market Update

Short-term interest rates have moved slightly downward with the 3-month T-Bill ending May at 0.06%, down from 0.12% as of December 31, 2010. The 10-Year T-Note ended May at 3.05% compared to 3.30% at December 31, 2010.

In the first five months of 2011, the Dow Jones Industrial Index climbed 8.57% while the Nasdaq Composite Index rose 6.88%. The banking sector, conversely, has declined in 2011 with the Nasdaq Banking Index posting a decrease of 2.69% as of the end of May.

The chart to the left provides market pricing history for the banking industry compared to selected general stock market indices for the first quarter.

As shown in the chart, the general stock market has continued its upward climb in 2011. The decline in bank pricing appears to be related to

concerns about bank profitability. Among the profitability issues are the slow economy which has led to falling loan balances, the Durbin Amendment (see above), and potential exposure from mortgage securitizations. The extensive media coverage of the Consumer Financial Protection Bureau’s lead role in the proposed loan servicing agreement with major servicers has caused many to worry about the CFPB’s future role in banking oversight.

Merger and Acquisition Activity

For the first five months of 2011, there were 58 bank and thrift announced merger transactions. This activity is comparable to last year (59 transactions). The median price to tangible book for transactions involving bank sellers was 101%.

Capital Market Services

Young & Associates, Inc. has a successful track record of working with our bank clients in the development and implementation of capital strategies. Through our affiliate, Capital Market Securities, Inc., we have assisted clients in a variety of capital market transactions including valuations, buy-back programs, the purchase and sale of offices, and merger and acquisition activity. For more information on our capital market services, please contact Stephen Clinton at 1.800.376.8662 or sclinton@younginc.com. □

Bank Investor Notes

By: Stephen Clinton, President
Capital Market Securities, Inc.

The big news for bank investors in the first quarter was the news that the Federal Reserve has approved plans for a number of large banks to increase their dividend payouts and for some to permit share repurchase activity. This

is meaningful in that it indicates that the banking regulators believe that the banking crisis is nearing an end.

We are seeing some heightened interest in merger and acquisition activity this year. While the pricing on recently announced deals is disappointing, the return of bank buyers to the market is a good sign.

Approximately 75% of the nation's banks were profitable in the fourth quarter of 2010. Despite the talk of lack of lending, banks increased their loan balances in the December quarter by approximately 1%.

Bank prices declined modestly in the first five months of 2011, while the general stock market improved. We anticipate that banks will report good earnings for the June quarter. This should result in improved pricing as we move toward the end of the year.

Overall, we think that the banking sector is undervalued. On a price-to-earnings perspective, the industry is trading at a significant discount to the general market. We believe that investors who invest in quality banks will be rewarded as the uncertainties surrounding the industry become resolved. □

A Plea For Your Perspective

By: Adam J. Witmer, CRCM, Compliance Consultant

Comments take time. Comments take an understanding of potential rules that don't necessarily affect us today. Comments are not required. Still, comments make a difference.

Rules and regulations for financial institutions have been changing at a rate faster than ever before. With the implementation of the Consumer Protection Bureau and other provisions of the Dodd-Frank Act going into effect this summer, we can expect these changes to continue at this extremely rapid pace over the next several years.

As many of us have experienced, the problem with rapid changes in regulations is that many of them either don't work as intended or have unexpected consequences, not to mention that they are often impractical or extremely difficult to implement in our shops. When changes are quickly forced upon the industry without an educated understanding of the full implications of the change, the consequences can result in inefficient implementation, reduced products and services, wasted resources, and unhappy customers. Therefore, it is imperative that we in the industry fully participate in the rule making process; we need to submit more comment letters now than we ever have before.

Even in understanding this importance, we still often struggle to justify the work it takes to draft a comment letter. One of the easiest excuses for not writing a letter is to tell ourselves that writing another letter is really just a waste of time. However, try considering these very good reasons why your opinion is important before you rule out sending in your next comment letter:

1. The process requires your perspective. The open comment period is written in as part of the rule-making process. This is our opportunity, as industry experts, to express our concerns and ideas; this is our contribution to help educate those developing the rules to better understand what will and won't work from both a practical and logistical perspective.

2. A perspective can speak volumes. We have been observing that consumer advocacy groups are working very actively to ensure every available comment and complaint is sent in as a formal comment. This "volume approach" can easily allow the comments submitted by consumers to far outnumber

Adam Witmer, CRCM Compliance Consultant

We are pleased to announce that Adam Witmer has joined Young & Associates, Inc. as a Compliance Consultant, serving client banks in the Midwest. Having nearly 10 years of experience in banking, Adam performs in-bank compliance consulting, conducts compliance training, and writes articles for various compliance publications. Prior to joining Young & Associates, Inc., Adam served as an officer and Director of Compliance for a multi-bank holding company in the Midwest. He has held the titles of Compliance Officer, BSA Officer, and CRA Officer for multiple banks, and has experience in the areas of compliance, training, internal audit, privacy, deposit and loan operations, retail banking, and secondary market lending. He earned the designation of Certified Regulatory Compliance Manager (CRCM) from the Institute of Certified Bankers. In addition he holds a BA in Business Administration from Taylor University and an MBA in Management and Human Resources from Indiana Tech.



those sent by financial institutions. This imbalance would not be easily overlooked by those designing the rules.

3. Our comments are heard. While we often think our comments really don't make a difference, the reality is that our comments are read and, to at least some degree, considered. An effective comment will often be addressed in the commentary section of a final rule submitted in the Federal Register. Proposed rules are often redesigned to address certain concerns brought to light from public comments.

The truth is, writing a comment letter does not have to be an all-inclusive, overwhelming task. Instead of trying to write a doctoral thesis for every proposal that comes out, try considering a simple submission on areas you are familiar with. Often, these "simple submissions" can be just as effective as the comprehensive thesis, especially when the volume increases on a topic.

The following practical tips are designed to help you COAST through your next comment letter:

Choose Your Battles

Remember that you don't have to comment on everything found in a proposal, so stick to what you know. If a particular area is not your strength, send a joint letter with someone who is familiar with the topic.

Outline Your Comment

In developing your response, "map" it out first. A quickly created outline will go a long way in motivating you to finish the project.

Apply a Brand

After you have outlined your letter, use one or two "big picture" points to create and apply a theme. Branding your letter this way will help to drive home your key points and keep your letter focused.

Substantiate Your Comments

Once you have stated your opinion, justify it with the "details" and give a solid explanation to prove your case. Work to support your points with existing guidance, court cases, and contradicting regulations or advisory opinions.

Tie It All Together

When editing your draft, ensure the document circles back to the beginning of your letter to bring everything together. The final product should be autonomous, a self-explanatory and independent document.

As these new regulations inevitably will appear, Young & Associates, Inc. stands ready to help. Should your bank need additional guidance, please feel free to contact us at 1.800.525.9775 or awitmer@younginc.com. □

Current Expectations for ALLL

By Fran Samson, Consultant

While there haven't been recent changes in the Allowance for Loan and Lease Loss (ALLL) guidelines, the approach taken for the completion of the reserve analysis is taking a new face, prompted primarily by the added attention from banking regulators. This is true especially for those banks that have been experiencing an increase in problem credits.

Determining ALLL

Several years ago, the ALLL process was enhanced with the addition of environmental factors being used to determine the reasonableness of the bank's potential losses. Historical losses were no longer the sole factor in establishing the required reserve for a portfolio. It would seem reasonable to take into account the effectiveness of the bank's loan review system, the level of

“ . . . using a proper approach to ALLL will show that your bank is proactive in risk management.”

experience in the lending staff, and the local, state, and national economy (to name a few of the factors) to determine the appropriate levels of reserve.

With an analysis of the reserve calculation being carried out every quarter, the process appears to be improving in the majority of banks. However for the banks whose delinquency numbers are increasing along with the number of classified credits, the ALLL calculation has become more time-consuming with the completion of the FAS 114 calculation for impaired loans. In addition, these banks are also under a more watchful eye of the banking regulators. Accurate completion of the analysis is more important than ever. Banks are finding out how underestimating the reserve requirement can impact their capital position when examiners require the reserve to be amplified, with the additional funds coming directly from earnings immediately.

A loan is considered impaired when it is likely the lender will not collect the full value of the loan because the creditworthiness of a borrower has fallen. If the loan is considered impaired, the FAS 114 is completed on an individual basis.

To determine if a specific reserve is needed, the bank has three options to calculate whether the collateral coverage is sufficient:

1. Present value of expected future cashflows
2. Fair value of collateral (less cost to sell)
3. Observable market price of the loan

In this writer's banking experience, the observable market price is not typically used. Most small- and medium-sized community banks have opted to use the fair value of the collateral less the cost to maintain and liquidate the property. Recently however, banks are being asked by their regulator to calculate present value of expected future cashflows on some of their impaired credits; in the case of a loan classified as a Troubled Debt Restructure, the present value of expected future cashflows option is required to determine what the impact of the lower interest rate granted will have on the bank's earnings.

It is likely the present value of expected future cashflows option was avoided, as the accounting calculation according to GAP looks very complicated. Therefore, banks opt to take a simpler approach by using the market value. However, if the market value is determined by discounting an older appraisal, it is likely that the examiner will require an updated appraisal.

If the loan is considered collateral dependent (the repayment of the loan is dependent on the liquidation of the collateral), the bank is required to use the fair value method in determining the adequacy of collateral coverage. Again, if the bank is using an older appraisal and applying a larger discount to the original value, it is likely to receive criticism from its regulator. The bank should obtain an updated appraisal to substantiate the collateral coverage assumptions.

Conclusion

The ALLL process is part of the bank's risk management that requires the identification and monitoring of the level of risk in the credit portfolio. Reasonable assumptions, along with accurate processes, validate that the bank is being diligent in the assessment of potential losses. In addition, using a proper approach to ALLL will show that your bank is proactive in risk management.

Young & Associates, Inc. offers several products and services that address the ALLL. For more information on this article or on how we may assist you in this area, please contact me at 1.800.525.9775 or fsamson@younginc.com. □

Customizable ALLL and Reserve Policy (#077) – \$175

Addresses the bank's responsibilities to monitor its portfolio for adequate ALLL, including methodology, portfolio analysis, and examination guidelines. To order [CLICK HERE](#) or call 1.800.525.9775.

The Mortgage Origination “Revolution” Has Hit Hard...and Vaguely

By: Mike Lehr, Human Resource Consultant

Recent regulatory changes hit no job function harder than mortgage loan origination. This includes mortgage loan officers, mortgage originators, and mortgage brokers (herein referred collectively as mortgage originators). Community banks need to make sense of these still rather vague and potentially conflicting changes. At the fore are the following major regulatory changes:

- Federal Reserve Board’s (along with the OCC, OTS and FDIC) requirements for boards to monitor incentive compensation plans. (This would apply to loan originators who also perform managerial or executive functions.)
- Wage and Hour Division of the Department of Labor’s Opinion Letter, stating that loan officers in financial services organizations are not exempt employees under the Fair Labor Standards Act.
- Federal Reserve Board’s final rules regarding the Truth in Lending Act and Regulation Z, stating that mortgage originators’ compensation cannot be based upon loan terms or conditions. This essentially prohibits almost any compensation-based-upon yield spread premium, and possibly includes raises to salaried-only mortgage loan officers based upon loan profitability.

Challenges for Community Banks

From a community banking perspective, these changes are especially challenging because of the multi-faceted role a mortgage originator can play. In large corporate banks, where job functions are narrowly defined, compliance is easier. The “wearer of many hats” environment of community banks makes compliance challenging. With Dodd-Frank hanging in the wings of rulemaking, this might change our thinking and approaches again. Therefore, while community banks can, with good intentions and with the best available knowledge, they should prepare themselves and their people for mid-stream corrections.

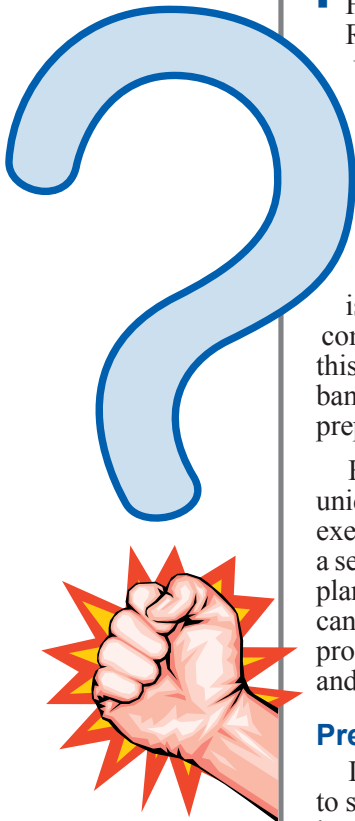
However, in doing so, community banks should be prepared to defend their own unique facts and circumstances. For instance, mortgage originators could remain exempt if they are performing other significant duties. Also, originators who have a senior managerial or executive function could retain their incentive compensation plan if their respective boards perform the right due diligence. Mortgage originators can still be compensated based upon the size of the loan, so some compensation programs might only require small changes. Moreover, what’s considered a term and condition of a loan isn’t as clear as it needs to be.

Preparing Your Defense

In preparing for such a defense, the first step is to consult with the bank’s counsel to see if the bank’s unique facts and circumstances fit some of the exceptions built into the regulations. It is not unusual to find an officer in one bank performing four different functions that are done by four different people in a larger bank. Moreover, from one community bank to another, those same four functions aren’t necessarily grouped in the same way and given to the same officer in another bank.

Regardless of whether such a defense is in order, a “continuing with the norm” or a “do-nothing” approach is not wise. Bank boards (for banks over \$175 million in assets) will need to increasingly show that they were aware of and examined their banks’ incentive plans so as not to put the bank at risk, including the incentive plans of mortgage originators. Additionally, banks will need to consider mortgage originators as non-exempt unless they can demonstrate otherwise. They will also need to show how their compensation programs for every single mortgage originator does not violate the new, supercharged Reg Z. Finally, community banks will most likely need to make sense of these changes for mortgage loan originators even if they think they don’t make sense and don’t apply to them.

We have learned about the changes to mortgage origination. We now need to adapt to them . . . more than once. □



Give Us a Call

For more information on how Young & Associates, Inc. can assist your bank in the area of compensation, give us a call at 1.800.525.9775 or send an e-mail to mlehr@younginc.com.

Liquidity Cash Flow Planning and Stress Testing Model (#271) – \$950*

Perform quantitative liquidity assessments as required by the *Interagency Guidance on Funding and Liquidity Risk Management*.

- Forecast funding sources, funding needs, and cash flow gaps
- Monitor availability of contingent liquidity
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- Perform liquidity stress testing and multiple-scenario what-if analyses

* Includes 1 year of technical support.

System Requirements: Microsoft® Excel

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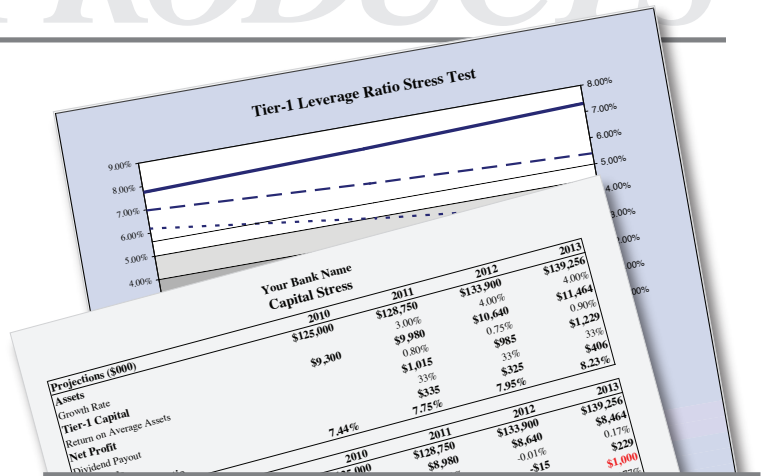
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Capital Stress Testing Model (#288) – \$149

A practical risk management tool that will assist bank management and the board in conducting effective, proactive capital planning. Easy-to-use and understand, this Microsoft® Excel-based spreadsheet allows you to create useful “what-if” scenarios to determine the impact of unexpected change in net income on the bank’s capital level over a three-year period. While not a regulatory requirement, a capital stress provides an important tool for the development of a Capital Contingency Plan.

System Requirements: Microsoft Excel 2002 and higher

Appraisals and Evaluations Policy (#124) – \$225

Young & Associates, Inc. has recently updated our Appraisal and Evaluations Policy to incorporate the requirements of the *Interagency Appraisal and Evaluation Guidelines* released on 12/10/10.

This customizable policy template covers:

- Appraiser and Evaluator Qualifications and Selection
- Engagement Letters
- Appraisals From Other Financial Institutions (including purchased participations)
- Third-Party Arrangements
- Useful Life of Appraisals
- Appraiser/Evaluator/Lending Staff Independence
- Appraisal/Evaluation Review
- Appraisal Audits for Loans Sold on the Secondary Market
- Reappraisals or Reevaluations of Collateral
- Representations and Warranties

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