

# the Competitive Edge

for Community Banks

## Looking For The Silver Lining

### Financial Crisis Creating Opportunities

The financial crisis has severely damaged many large financial institutions, as well as economies around the globe. But for many community banks, this dark cloud may have a silver lining.

#### Weathering The Storm

The subprime mortgage market's collapse led to some of the largest financial institution failures in U.S. history and forced several venerable investment banking and mortgage companies to shut their doors. Many of the institutions that have survived have severely curtailed or eliminated lending secured by single-family homes. Your bank may be positioned to fill the void.

If, like most community banks, yours steered clear of the subprime mortgage market, it's likely that your residential mortgage business remains relatively healthy. The key term here, of course, is "relatively." Your community bank certainly isn't immune to declining housing prices, tightening credit and a struggling economy that's affecting all financial institutions. The good news is that you managed to stay in the eye of the subprime storm, giving you an edge over many of your larger competitors and putting you in a good position to grab market share as the economy recovers.



#### Forecast Hazy

Although the economy's precarious state should concern all businesses, community banks may have reason to be optimistic, as indicated by a recent Annual Real Estate Lending Survey Report, published in February 2008. Keep in mind that the survey was conducted after the subprime mortgage collapse, but before the events that led to the government bailout.

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At that time, 39% of financial institutions expected single-family lending to increase, while another 39% expected it to stay the same. As the ABA observed, “This forecast is consistent with the often expressed view that community banks are well positioned to gain market share as other lenders falter.”

Indeed, the nature of utilizing community banks gives you a decided advantage. As larger players exit the market, local financial institutions are increasingly viewed as the best alternative. And despite an overall decline in residential mortgage applications, some community banks have seen increased application numbers. What’s more, without large financial institutions underbidding you, your community banks may even enjoy a more favorable pricing environment.

The potential benefits for your community bank extend beyond residential lending. In the wake of the subprime collapse, many large financial institutions also are re-evaluating their commercial lending programs, especially for small businesses. This is likely to open up new opportunities for local community banks. The industry also may see growth in deposits as weary investors seek shelter from the volatile stock market.

### **Bring An Umbrella**

The forecast for community banks seems relatively clear, but conditions can change quickly, so it’s important to exercise caution. Your community bank shouldn’t abandon the conservative lending standards that helped shelter it from the subprime mess in the first place. Much of the new lending business created by the withdrawal of large financial



institutions from local markets involves greater credit risk. So although these borrowers aren’t considered subprime, many of them have credit issues or would have been candidates for low-documentation loans at larger institutions.

As you take advantage of opportunities to increase your market share and boost pricing, don’t lose sight of credit quality. Maintain your credit standards, pay attention to risk management and look out for business and economic trends that may harm your customers. These days, seemingly strong customers can become problem borrowers overnight. Closely track loan quality statistics and other data that can signal borrower trouble.

If your community bank isn’t currently involved in residential lending, these opportunities may be

attractive. But keep in mind that residential lending involves relatively complex underwriting methodologies and a rigorous regulatory framework. The cost of noncompliance can easily wipe out any potential earnings. If you lack the in-house expertise to manage compliance with residential lending regulations, be sure to engage qualified outside consultants to assist you.

### **Enjoy The Weather**

Despite the gloomy economy, your community bank has a unique opportunity to build its business. To take advantage of the chance, ramp up your marketing efforts and renew relationships with realtors, appraisers, homebuilders and other referral sources. So long as you continue to follow sound lending practices, your community bank will be prepared to weather this and future economic storms.

# How To Put The “L” In CAMELS

## Liquidity Risks

The most successful community banks are the ones with solid systems for monitoring and managing risk. Historically, liquidity risk wasn't at the top of most banks' list of concerns. But last year's subprime mortgage crisis and ensuing credit crunch have made it a priority for banks as well as regulators.

Liquidity risk is particularly insidious because it can take down banks that are financially sound. Consider the recent failure of IndyMac Bank, the 11th largest producer of U.S. home mortgages. IndyMac had been profitable until last year's credit crunch caused it to post its first annual loss in its 23-year history. The bank was certainly struggling and had even been warned by regulators that they no longer considered it to be “well-capitalized.” But insufficient liquidity was ultimately responsible for IndyMac's demise.

Ironically, it was a letter from a U.S. senator to federal regulators questioning IndyMac's solvency that caused nervous customers to withdraw \$100 million in deposits. As the Wall Street Journal explained in a July 16 article this year, “Access to short-term cash can make the difference between a bank that weathers a rocky period and one that is brought to its knees, as IndyMac Bank was last week....”

### Liquidity Matters

Banking regulators have a useful tool, CAMELS, to evaluate and monitor a bank's financial condition. The CAMELS rating system is based on:

- Capital adequacy,
- Asset quality,
- Management,



- Earnings,
- Liquidity, and
- Sensitivity to market risk.

Traditionally, regulator focus has been on capital adequacy and asset quality. But, in recent years, there has been growing recognition, by the federal banking agencies and industry experts, of the impact liquidity can have on a bank's financial condition. Reasons for the increasing importance of liquidity include shrinking core deposits and investment strategies that focus on yield rather than liquidity.

An article in the FDIC's Winter 2007 issue of Supervisory Insights (“Liquidity Analysis: Decades of Change”) notes how easy it is to take liquidity for granted when times are good. But in an economic downturn, the authors maintain, “liquidity can quickly be elevated to the most important CAMELS component.” Even a bank with good asset quality, strong earnings and adequate capital can fail if it lacks the liquidity to meet its current obligations.

### How To Form A Plan

Every bank should have a plan for managing liquidity risk. The right plan depends on such factors as your bank's investment policy and strategic plan, its size, its mix of products and services, and its liquidity risk profile. But in general, you should follow these five steps:

#### *Evaluate your liquidity position.*

Take inventory of your assets and determine which ones can be quickly converted into cash (for example, cash equivalents, readily marketable assets, assets that can be pledged as collateral). Also look at liabilities that might create liquidity problems, such as deposits or borrowings that are nearing maturity.

#### *Assess your liquidity risk.*

In simpler times, banks relied primarily on retail deposits to fund loans and the main liquidity threat was deposit runoff. Most banks could meet their liquidity needs by tapping their investment portfolios. Under these

circumstances, liquidity risk could be measured using simple financial statement ratios, such as liquid assets/total assets or total deposits/total loans.

But times have changed, and managing liquidity risk has become more complicated. Dwindling deposits means more banks rely, to some extent, on alternative funding sources. And the availability and cost of these funds are affected by a variety of market forces. In addition, many banks invest in higher-yielding, illiquid securities and pledge a larger portion of their liquid holdings as collateral for borrowings.

Static financial statement ratios, therefore, no longer provide an accurate picture of a bank's liquidity risk. Today, smart bank managers are assessing liquidity risk using sophisticated cash-flow projection and financial modeling techniques that take into account a range of potential scenarios that could create liquidity stress.

**Implement an early warning system.** Once you've assessed your institution's risks, identify and monitor your bank's key risk indicators. These include changes in certain financial ratios as well as deteriorating asset quality and external factors.

**Plan for contingencies.** It's important to have a contingency funding plan in the event your bank faces liquidity challenges. Many banks already use alternative funding sources, such as Federal Home Loan Bank (FHLB) advances, brokered deposits and repurchase agreements. But keep in mind that these solutions introduce risks of their own. (See "Alternative Funding Sources" below) If your contingency plan relies on these sources, test them periodically to ensure that they're available when you need them. If you wait for a crisis before attempting to tap them, you may run into unforeseen obstacles.

Your bank's investment portfolio remains an effective buffer against

liquidity risk. Recently, the Basel Committee recommended that banks maintain "a robust cushion of unencumbered, high quality liquid assets to be in a position to survive protracted periods of liquidity stress." This is a costly proposition, however, so it's important to determine the appropriate liquidity buffer in light of your institution's specific risk profile.

**Document your plan.** No matter how strong your plan, it will be of little value if it's not properly documented. Provide detailed guidance on the actions management should take so that, when liquidity problems arise, you can respond without hesitation.

### How To Prepare For Dry Spells

Four-legged camels can go without water for two weeks or more, allowing them to survive long trips through the desert. CAMELS is, thus, an apt acronym; banks need backup sources of liquidity to help them survive inevitable dry stretches.

## ALTERNATIVE FUNDING SOURCES

There are a variety of alternative funding sources available to help banks meet their liquidity needs. Here are a few examples:

**Federal Home Loan Bank.** FHLB advances provide a low-cost source of funds that can help banks manage both liquidity risk and interest rate risk. Keep in mind, however, that some FHLB branches have cut back on advances in the wake of the mortgage crisis. Also, the FHLB's imposition of prepayment penalties on some advances, as well as its ability to call or reprice certain advances, can create mismatches between these advances and the loans that fund them.

**Brokered deposits.** Deposit brokers, such as the Certificate of Account Registry Service (CDARS), provide liquidity by placing deposits with your bank. CDARS enables depositors to insure very large sums by placing funds with multiple banks in increments less than the \$100,000 limit on FDIC coverage.

**Repurchase agreements.** These transactions allow banks to raise cash by selling a security to a broker-dealer for a specified price and then buying it back at a later date for a slightly higher price. In substance, it's the equivalent of pledging the security as collateral for a secured loan.

It's important to recognize, though, that when you pledge a security it's no longer available as a liquidity source. And if your bank's financial condition deteriorates or the security's value declines, the broker-dealer may demand additional collateral.

# Audit and Reporting Rules Tightened Under FDIC Plan

Proposed changes to FDIC regulations would tighten annual independent auditing and reporting requirements for community bankers. The FDIC says the proposed amendments to Part 363 of its regulations reflect “changes in the industry” and include certain “sound audit, reporting, and audit committee practices” from the Sarbanes-Oxley Act of 2002 (SOX).

The changes would apply to FDIC-insured institutions with \$500 million or more in total assets. The public comment period ended on Jan. 31, 2008 — nearly a year ago — but at press time the FDIC had not yet finalized its proposed changes. Regardless of the outcome, the proposal reflects banking regulators’ interest in extending at least some of SOX’s requirements to privately held banks.

## What’s Required Now?

Until it was amended in 2005, Part 363 required banks with \$500 million or more in total assets to file an annual report with the FDIC and other federal and state banking regulators. Reports were required to contain:

- Audited financial statements,
- A statement of management responsibilities,
- Management’s assessment of the effectiveness of internal controls over financial reporting, and
- An independent public accountant’s attestation report on internal controls’ effectiveness over financial reporting.



The regulations also required covered banks to establish an independent audit committee comprising outside directors who are independent of bank management.

In November 2005, the FDIC amended the regulations to raise the asset threshold to \$1 billion for requirements 3 and 4. And for banks with total assets between \$500 million and \$1 billion, the 2005 amendments provided that only a majority of the audit committee must be independent.

## What Would The Proposal Change?

The FDIC’s proposed amendments would, among other things:

- Require management reports to identify the internal control framework, disclose all identified material weaknesses and assess the bank’s compliance with certain safety and soundness laws and regulations,
- Clarify that a public accountant’s independence is determined according to the

standards and interpretation of the Public Company Accounting Oversight Board (PCAOB) and American Institute of Certified Public Accountants,

- Incorporate audit committee independence criteria from the National Securities Exchanges’ listing standards,
- Incorporate certain SOX requirements that specify the audit committee’s duties and require auditors to report to the committee all communications with the bank on critical accounting policies, alternative accounting treatments and schedules of unadjusted differences, and
- Extend the annual report filing deadline for nonpublic banks by 30 days and establish a late filing notification requirement in place of the current system, which allows banks to request an extension in the event of “extraordinary circumstances.”

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The FDIC received a number of comments on its proposal, many of which objected that the amendments would needlessly increase the regulatory and administrative burden on privately held community banks. (Public banks are already subject to SOX.) The Independent Community Bankers of America (ICBA), for example, argued that when Congress passed SOX it “did not intend the PCAOB to become the accounting standard setter for auditors that perform audits of private companies.”

The ICBA also expressed concern that tighter independence requirements for auditors would create challenges for banks in locations with limited access to accounting firms. Similarly, stricter criteria for audit committee independence may make it more difficult for some community banks to find directors who meet the criteria to serve on their audit committees.

Finally, the ICBA felt that the new management report requirements would significantly complicate the preparation of the report. It worried that the new auditor communications rules would inappropriately diminish the

role of management in privately held banks.

**Stay Tuned**

If adopted, the proposed FDIC amendments would have a significant impact on your bank’s audit and reporting requirements. Be sure to monitor further developments, and consult your advisors to discuss the implications for your institution.



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