Community Banking
ADVISOR

Winter 2010

Credit card overhaul
Comprehensive Reg Z and
UDAP changes take effect July 1

OTTI: What it is and why you should care about it

Managing vendor risk

Do you have a capital defense plan?

www.elliottdavis.com

Do you have a capital defense plan?

Regulators are scrutinizing community banks like never before. One of their biggest concerns is whether banks have adequate capital to withstand potential losses associated with high concentrations of commercial real estate (CRE) loans. Banks with a dangerously high level of CRE risk may be required to raise additional capital; no easy task in today's environment. Undercapitalized banks also may be subject to FDIC-imposed rate caps. (See "Be aware of the 'national rate' safe harbor" on page 3.)

To protect yourself, develop a capital defense plan as part of your preparation for regulatory exams. By taking a proactive approach, you can manage risk more effectively and make examiners more comfortable with your strategies for facing today's challenges.

Commercial is the new residential

Home foreclosures and delinquencies may have triggered the current economic crisis, but CRE loans are receiving increasing attention. Recently, U.S. Comptroller of the Currency John Dugan observed that "the greatest challenge facing many banks … is the continued deterioration in commercial real estate loans."

Over the last few years, construction and development loans have accounted for a significant portion of loan growth, particularly among community banks. As demand for these properties dries up and existing buildings struggle to attract tenants, the number of delinquencies and defaults is climbing rapidly.

Despite recent improvements in the banking industry, FDIC chair Sheila Bair recently told lawmakers that "there will be more failures." Expressing concern about high concentrations of CRE loans, Bair suggested that as many as 100 banks could fail in 2010.

Preparation matters

Thorough preparation can make the difference between a positive and negative regulatory exam. Here are several best practices to consider:

Review regulatory guidance. Be familiar with the interagency guidance *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. The guidance, issued in 2006, outlines the elements of a solid risk management program, including board and management oversight, credit underwriting standards and stress testing. Be prepared to demonstrate that you're following the guidance or have a strategy for moving in that direction.

Also review the banking agencies' recent *Policy Statement on Prudent Commercial Real Estate Loan Workouts*. According to the Federal Reserve, banks that follow these guidelines will "not be subject to criticism … even if the restructured loans have weaknesses that result in

Be aware of the "national rate" safe harbor

The FDIC has amended its regulations regarding limits on deposit interest rates offered by institutions that are less than "well capitalized" according to FDIC standards. Under the new rule, issued in May 2009, interest rates paid by undercapitalized banks generally are capped at 75 basis points over a redefined "national rate."

Under the new rule, the national rate, which the FDIC publishes weekly, is "a simple average of rates paid by all insured depository institutions and branches for which data are available." Previously, the national rate was tied to yields on U.S. Treasury securities, which have been significantly lower than actual deposit rates, resulting in artificially low interest rate caps.

Keep in mind that the new rate caps merely establish a safe harbor: The national rate is presumed to be the prevailing rate in a market, but this presumption can be rebutted with evidence that prevailing rates in a bank's market are higher.

adverse credit classifications." In addition, reasonably restructured or renewed loans will not be subject to adverse classification solely because underlying collateral values have declined.

Review and classify your loan portfolio. Take a proactive approach to identifying problem loans and weaknesses, rather than waiting for examiners to uncover them. This will give you an opportunity to present the situation in the most favorable light and to explain the steps you're taking to address any problems.

Also, classify your loans into relevant categories, such as industry, geography, property type or borrower type. This will allow you to present examiners with a more meaningful picture of your bank's CRE risk. Commercial office buildings, for example, may be less risky than retail malls.

Examiners may assume that certain types of loans — such as those that have resulted in significant losses at other banks in your region — are highly risky unless you can demonstrate a borrower's capacity to continue servicing the debt over the long term. Be sure that you're able to document global cash-flow analyses and other steps you've taken to evaluate a borrower's ability to repay a loan.

Revisit your ALLL methodologies. Review and document the methodologies you use to determine the allowance for loan and lease losses (ALLL). It's particularly important to ensure that your assumptions — including historical loss rates — reflect current market conditions. Many banks look back three to five years in establishing their loss histories, but some examiners are limiting historical losses to as little as one year. Given the current state of affairs in the financial industry, such a policy can be devastating to a bank's capital position.

To protect yourself, be prepared to explain to examiners why a longer loss period provides a more accurate assessment of your bank's potential future losses.

Make good value judgments. Be sure you have effective policies and procedures for monitoring and adjusting collateral values. Assess the reasonableness of key assumptions on which the original valuation was based, and obtain new appraisals when existing appraisals are no longer meaningful.

Familiarize yourself with the latest developments in fair value accounting and work with your advisors to ensure that your securities holdings are classified and valued properly.

Test for stress. Stress testing is a highly effective technique for modeling the impact of fluctuating interest rates, changing economic conditions and other factors on asset quality, earnings and capital. Examiners expect banks to conduct periodic stress testing — at both the portfolio and the individual loan level — of their high-risk portfolios.

The best defense is a good offense

No one understands your business better than you. The best way to defend your capital in a regulatory exam is to prepare a presentation that accurately portrays your bank's strengths and weaknesses and outlines your strategies for meeting the challenges ahead. ▲

Credit card overhaul

Comprehensive Reg Z and UDAP changes take effect July 1

Banks that issue credit cards have until July 1, 2010, to line up their compliance strategies for a massively changed set of UDAP (unfair or deceptive acts or practices) and Regulation Z (truth in lending) rules. The Federal Reserve Board, the Office of Thrift Supervision and the National Credit Union Administration issued the rules in December 2008. Here's a brief summary of the revisions.

The UDAP rule

The UDAP changes cover a wide spectrum of issues affecting consumers, including:

Reasonable time to make payments. The rule prohibits a credit card issuer from treating a payment as late unless the consumer has been given a "reasonable length of time" to pay his or her bill. The rule doesn't define what's "reasonable," but provides a safe harbor for the issuer.

The UDAP changes cover a wide spectrum of issues affecting consumers, including payment allocation, interest rate increases on new and outstanding balances and double-cycle billing.

Payment allocation. The rule sets new requirements for the methods an issuer may use when allocating a consumer's payment to outstanding balances.

Interest rate increases on new and outstanding balances. The rule requires issuers to disclose the specific rates that will apply to each category of transactions, with certain restrictions. The rule also limits the ability of issuers to increase credit card rates, but identifies several exemptions relating to account-opening disclosure, variable rates, advance notes, delinquency and workout arrangements.

Double-cycle billing. The rule prohibits double-cycle billing but is limited to circumstances in which the two-cycle method results in interest charges due to the loss of the grace period.

Fee-based accounts. The rule prohibits an issuer from financing security deposits or fees for the issuance or availability of credit during the first year in certain situations. Plus, security deposits and fees exceeding 25% of the initial credit limit must be spread over six months.

Reg Z amendments

The amendments to Regulation Z are aimed at improving the effectiveness of disclosures for open-end accounts. They cover these major issues:

Credit advertising. Advertisements must 1) disclose the periodic payment amount on a plan offered to

finance the purchase of goods or services in a specified manner and 2) refer to a rate as "fixed" only if it specifies the time period for the fixed rate and if the rate won't increase for any reason during that time.

Credit account disclosures. The rule revises the form, terminology and format for all of the open-end credit disclosures governed by Reg Z.

Change in terms/45-day notice. Creditors must provide at least 45 days' (rather than the existing 15 days') notice to increase rates on new account transactions or to increase key fees.

Billing error resolution. In some situations, creditors will be prohibited from reversing funds that were previously credited to the consumer's account if the creditor determines there was no error.

Due dates for mailed payments. The rule provides a safe harbor for mailed payments that are treated as timely if received by 5 p.m. on the payment due date. Also, a creditor must treat a payment received by mail the next business day as a timely payment in certain situations.

Right to reject card and fees. Creditors can't collect any fee before providing account-opening disclosures, with some exceptions.

Getting help

If your bank is involved in credit card issuance, begin the change process now while keeping an eye on other amendments that are in the pipeline. Your CPA can help you with compliance and training issues relating to these changes or refer you to a qualified source. ▲

OTTI: What it is and why you should care about it

Over the last year or so, the financial world has focused a great deal of attention on fair value accounting and the Financial Accounting Standards Board's (FASB's) guidance on the subject. Much of that guidance has been designed to reassure companies that they need not value financial assets at fire-sale prices when markets for those assets are inactive or illiquid.

Another important accounting issue, particularly for banks, is the treatment of other-than-temporary impairment (OTTI) for investments. In mid-2009, FASB issued guidance that changes the way these impairments are recorded for certain securities. OTTI can have a significant impact on bank earnings and regulatory capital, so it's important to have policies and procedures in place to deal with OTTI and to document your assessments carefully.

What is OTTI?

A debt or equity investment is impaired if its fair value is less than its amortized cost basis. If that happens, a

bank must determine whether the impairment is other than temporary. Factors to consider in making this determination include:

- The length of time the security's fair value has been below its carrying amount,
- The issuer's near-term prospects, and
- The bank's intent and ability to hold the investment long enough to allow for any anticipated recovery in value.

Under previous rules, assets that experienced OTTI were written down to fair value, with a corresponding charge to earnings. Many banks felt that this treatment was unfair, particularly for securities they had no intention of selling.

In a depressed market, a debt security's fair value may decline even though there's little or no change in the underlying cash flows.

In a depressed market, for example, a debt security's fair value may decline even though there's little or no change in the underlying cash flows. Arguably, a requirement that the holder write down the security to fair value, even if it intends to hold it to maturity, doesn't fairly represent the underlying economics.

How does the new guidance work?

The new rules treat equity securities in essentially the same way as before, but they make significant changes to the treatment of debt securities classified as available-for-sale or held-to-maturity. If a bank determines that a debt security is other-than-temporarily impaired, it must then determine whether it intends to sell the security — or it's more likely than not that it will be required to sell the security — before its anticipated recovery.

If the security is likely to be sold, the total amount of OTTI is written down and recognized in earnings. If it's not likely to be sold, however, only the *credit component* of OTTI — that is, the loss attributable to the issuer's inability or unwillingness to pay — is recognized in earnings. The noncredit component — which reflects losses caused by illiquidity, fluctuating interest rates or other factors — is recognized as other comprehensive income (OCI).

There's no prescribed method for estimating the credit component of OTTI, although FASB's guidance notes that one acceptable methodology is the same method used to account for the impairment of a loan. That method generally involves calculating the present value of expected future cash flows discounted at the effective interest rate.

Why does it matter?

Properly allocating OTTI between its credit and noncredit components is important for two reasons. First, by flowing through OCI, the noncredit component won't reduce your bank's earnings. And second, the noncredit component won't affect your bank's Tier 1 capital.

To minimize the impact of OTTI on earnings and regulatory capital, be sure that your bank has policies and procedures in place for classifying securities, determining fair value, assessing securities for OTTI and measuring the credit and noncredit components. ▲

Managing vendor risk

Many banks outsource a variety of activities, from office cleaning to data processing to anti-money-laundering compliance. The advantage of outsourcing is that it allows you to shift day-to-day performance of a function to a third party, freeing up your time to concentrate on your bank's core functions. But that doesn't mean you can sign the contract and forget about it. You can't absolve yourself of the responsibility.

Federal regulations require banks to develop and maintain a vendor management program designed to protect customer information. And while these requirements may seem daunting, especially for smaller community banks, a risk-based approach can minimize the burden.

What the law requires

The Gramm-Leach-Bliley Act (GLBA) and its regulations require financial institutions to take various steps to provide administrative, technical and physical safeguards for customer records and information, including vendor oversight. To comply, your bank must:

- Exercise appropriate due diligence in selecting service providers,
- Require service providers, by contract, to implement appropriate information security measures, and
- Monitor service providers, if indicated by your bank's risk assessment.

Monitoring involves reviewing audits, summaries of test results and other equivalent evaluations of a service provider. For high-risk vendors, the bank should monitor and validate controls through periodic self-assessments or other means. High-risk vendors would include outsourced core processors, Internet-banking providers and vendors with information on customers that would be a risk if someone else had access to it.

Risk assessment

The GLBA emphasizes a risk-based approach to compliance. The appropriate scope of your vendor management program depends on your bank's size and risk profile. The first step in designing a program, therefore, is to conduct a risk assessment. First, take inventory of all of your vendors that have access to or control of customer information. Next, list the type of access each vendor has, such as physical access, remote or on-site electronic access, and so on.

Finally, prioritize your vendors according to their level of access and the potential impact a breach would have on your bank and its customers. Keep in mind that access is not necessarily defined by job function. A janitorial service may not deal with customer information, but it may have physical access to such information if, for example, it's allowed to work unsupervised in a room with unlocked filing cabinets.

Planning ahead

Based on your risk assessment and available resources, you can establish appropriate policies and procedures for selecting vendors, reviewing service contracts and overseeing vendor operations. ▲

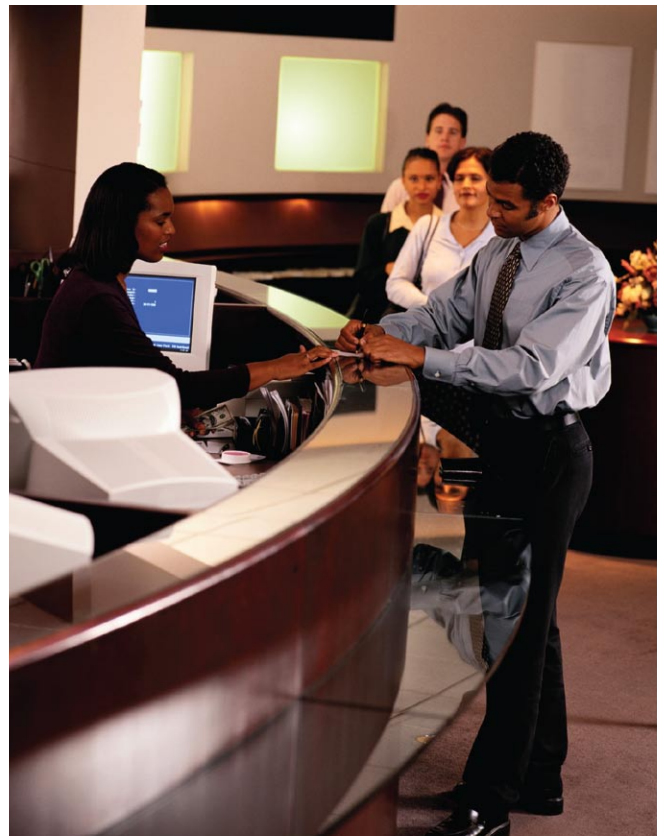
This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2010 CBAwi10

elliott davis *: for you*

P.O. Box 6286 • Greenville, SC 29606 - 6286

With a team of professionals exclusively dedicated to serving financial services clients, Elliott Davis provides audit, tax and consulting services to more than 100 financial institutions, ranging in size from de novo status to more than $3 billion in assets. Serving both public and private institutions, our services include:

- Assurance services
- Tax services including compliance and planning
- Outsourced internal audit
- SEC registration and compliance
- Preparation of 10-Qs and 10-Ks
- SOX 404 documentation and testing
- BSA compliance reviews
- Information systems audits
- SAS 70 Reports
- Strategic planning
- Mergers and acquisitions
- Management and regulatory services
- Loan reviews
- Director training
- ALCO model testing
- Stock compensation calculations



With offices located throughout the Southeast, members of Elliott Davis' Financial Services Practice quickly respond to clients' needs. Please contact us at 877.340.6802 to tell our team about your financial institution's goals and to learn how we can help you achieve them. Visit us online at www.elliottdavis.com.