



Community Banking Advisor

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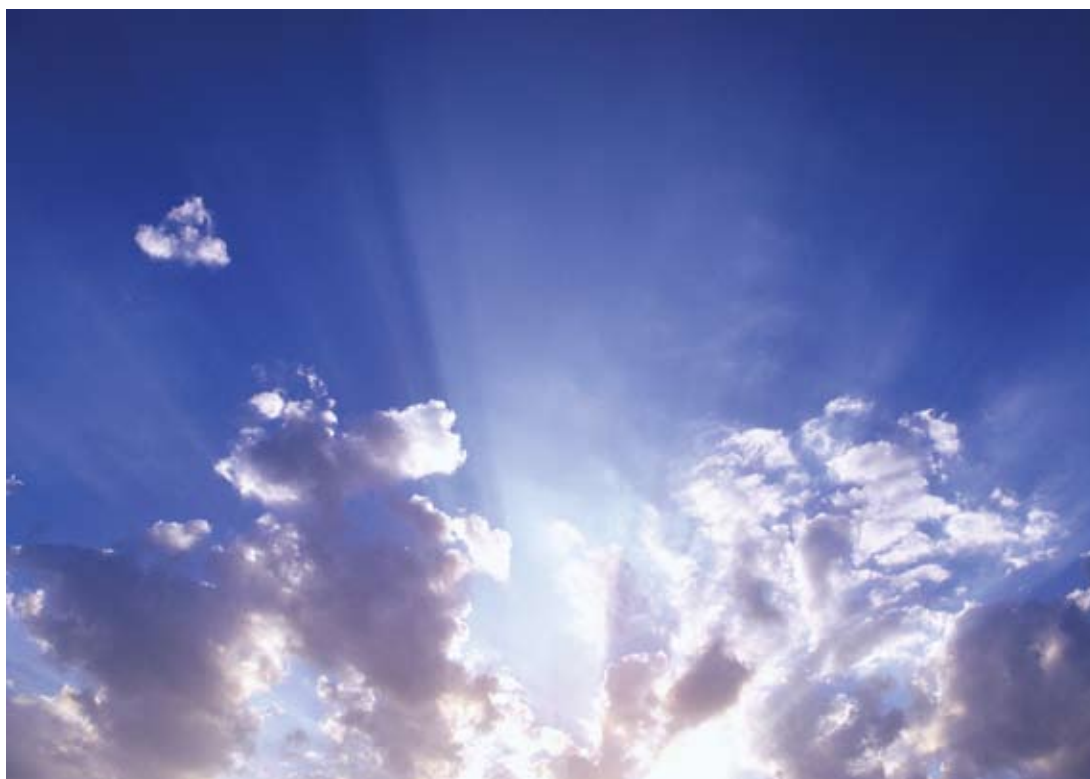
Financial crisis creates opportunities

The financial crisis has severely damaged many large banks — 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 bank 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 community 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 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 bankers may have reason to be optimistic, as indicated by the American Bankers Association's *15th 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.

As larger players exit the market, community banks are increasingly viewed as the best alternative.

At that time, 39% of community bankers 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 community banking gives you a decided advantage. As larger players exit the market, local banks

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 banks underbidding you, your bank may even enjoy a more favorable pricing environment.

The potential benefits for your 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 banks. The industry also may see growth in bank 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 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 banks 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 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, home-builders and other referral sources. So long as you continue to follow sound lending practices, your bank will be prepared to weather this and future economic storms. 📧

Checking your vitals

Use KPIs to monitor your bank's financial health

Most prudent people see their doctors for regular checkups even if they feel fine. A physical exam can provide an early warning of potential problems before they become more serious.

For similar reasons, banks should continually monitor their vital signs — also known as key performance indicators (KPIs). KPIs can alert you to dangerous conditions while there's still time to react, providing you with invaluable information you can use to boost profits.

Custom treatment

There are many KPIs that you can use to measure your bank's performance and compare it with the competition's. (See the sidebar "Running a few tests" on page 4 for examples.) In addition, tying compensation to KPIs can be an effective way to motivate employees to improve your bank's performance.

KPIs include a variety of financial ratios and other metrics, many of which can be pulled from your bank's financial statements or Uniform Bank Performance Reports (UBPRs). Consider benchmarking your bank's KPIs against industry or regional averages or against the top-performing banks in your area or the nation. If your numbers are significantly out of line, find out why and take action if necessary.

Although benchmarking against competitors and other industry players is a valuable exercise, it's even more



Running a few tests

You have dozens of key performance indicators (KPIs) — both financial and nonfinancial — to monitor your bank’s performance. Besides the efficiency ratio discussed in the main article, the more common ones are:

Liquidity ratios and limits. These include balance sheet ratios, such as total loans/total deposits or total loans/total equity capital. Other indicators try to quantify a bank’s ability to meet its funding needs, such as total and net overnight funding volume/total assets and liquid assets minus short-dated liabilities. The key is finding two or three liquidity indicators that reflect your bank’s particular liquidity needs and issues.

Uninvested funds. Tracking total uninvested funds (less reserve requirements) shows how well you’re keeping the bank’s funds invested and generating income.

Loan activity. Another valuable indicator is the amount of loan commitments at the beginning and end of each period. You also might track outstanding loans, new loans, ending total loans and the amount of principal reduction during each period.

Deposit activity. The total value and number of new deposit accounts, as well as closed deposit accounts during each period, provide a measure of your bank’s growth. Also, substantial increases or decreases in your bank’s largest deposit accounts may be significant.

Profitability ratios. Return on equity (net income/owners’ equity) can show how well management is providing a return for the bank’s owners. Return on assets (net income/total assets) measures operational performance.

Nonfinancial indicators. Measures — such as customer satisfaction or number of customer visits — also can represent insight into your bank’s performance.



important to tailor your analysis to your bank’s particular characteristics. Just as “normal” vital signs vary from person to person, a particular KPI may deviate from industry norms even when the bank is in good financial health.

A healthy dose of liquidity

To give you an idea of how important liquidity is to bank performance, the UBPR contains 12 different liquidity ratios that can be used as KPIs. But each bank is unique and may derive liquidity from different sources on both sides of the balance sheet — or even from off-balance-sheet activities.

Financial ratios can help you quantify liquidity, but many other qualitative factors influence your bank’s liquidity risk, such as borrowing capacity and deposit structure. Two banks may have identical liquidity ratios, but if one is more likely to experience early withdrawals, for example, its liquidity risk is much higher.

In a discussion of liquidity in its *Comptroller’s Handbook*, the OCC illustrates this point: “[A] well-capitalized bank may have a loan to deposit ratio of 90% and not have any liquidity problems, while another bank with the same ratio may be sapped of liquidity and nearly insolvent because it relied heavily on a concentration of short-term credit-sensitive deposits for day-to-day funding and on the Federal Reserve discount window for emergency funding.”

Apples compared to apples

When working with KPIs, be aware of the varying methods of calculating them. For any given ratio, there may be several alternatives for the information that goes in the numerator, the denominator or both.

Take, for instance, the efficiency ratio, which measures how effectively a bank generates revenue. The standard formula for computing the ratio is noninterest expense/(total income – interest expense). But some banks use the “gross income” approach: Efficiency ratio = noninterest expense/total income. The lower the resulting number, the more efficient the bank.

Unless you understand the components that make up a particular KPI, comparisons of your bank to other institutions, or even internal comparisons of different time periods at your own bank, can be misleading.

Symptoms to spot

For KPIs to have real value, you need to analyze them in light of your bank’s unique structure, size, location, product mix, risk profile and other attributes. Once you understand

what a KPI means for your institution and have determined an appropriate range of values, you can monitor it over time for negative trends and act before they become financial disasters.


For example, if your efficiency ratio is rising, you may be suffering from “overhead creep” — a progressive, almost imperceptible growth in overhead costs that can gradually eat away your profits. Alternatively, something may be happening on the revenue side, such as declining fee-based services or excessive fee waivers, that’s hurting your efficiency.

A report on the top-performing community banks in the June 2008 issue of *ABA Banking Journal* sheds some light on the strategies banks use to maintain their financial health. It notes that top performers in all categories “were more

efficient than their counterparts, posting average efficiency ratios of between 47% and 52%.”

The key to greater efficiency, however, wasn’t lower expenses, but higher revenues. Banks boosted revenue by selling branches, selling loan portfolios, and exiting markets or lines of business to focus their resources on more profitable activities.

To your health

Like dangerous health conditions, problems with your bank’s performance are easier to fix if they’re caught early on. By identifying your bank’s KPIs, monitoring them and reporting the results to management on a monthly, weekly or even daily basis, you can keep your finger on your bank’s pulse and react quickly to any potential threats. 

Audit and reporting rules toughened 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:

1. Audited financial statements,
2. A statement of management responsibilities,
3. Management’s assessment of the effectiveness of internal controls over financial reporting, and
4. 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."

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.

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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. 

Security interests

Is your online information protected?

As online banking continues to grow in popularity, even small banks are offering customers Web access to at least some of their products and services. But with this convenience comes an unwelcome byproduct: the threat of unauthorized access by hackers and identity thieves.

Information security is critical to maintaining customer relationships. Unless they're confident that their money and personal data are safe, customers may take their business elsewhere. So it's critical that you do everything possible to prevent online thieves from breaching your security.

What's your risk profile?

Despite the importance of information security, throwing money at the problem isn't the answer. And while there's virtually no limit to the security measures you can put into place, no community bank has unlimited financial or staffing resources to dedicate to the project.

The first step, therefore, is to conduct a risk assessment to identify the areas where your institution is most vulnerable and to focus your resources in those areas. Every bank is different, so an appropriate allocation of resources depends on a variety of factors, including the types of online services you offer and your bank's size, location and operational complexity.

Although not required, it's a good idea to hire an independent third party to conduct the risk assessment. Your own staff could view the bank's risks in terms of particular individuals rather than the activities themselves.

What type of security do you need?

Once you understand your bank's risk profile, you can design an information security plan tailored to meet its needs. Security measures you might consider include:

- Access controls to authenticate users and prevent access by unauthorized individuals,
- Controls that prevent employees from providing customer information to unauthorized individuals,
- Restricted access to physical locations that contain customer information, such as buildings, computer facilities and record storage facilities,

Should you outsource it?


As security threats become more sophisticated and customer information harder to protect, many banks are turning to managed security service providers (MSSPs) for help. These companies can provide greater security measures than you might generate internally because they monitor the latest hacker strategies and typically offer cutting-edge technology solutions.

Many MSSPs provide around-the-clock monitoring to detect suspicious activities and repel any actual attacks. If you use an MSSP, however, you still need to dedicate internal resources to information security — although external threats are a serious concern, many of the most damaging attacks come from within.

- Encrypted electronic customer information, whether in transit to offsite storage or stored on networks,
- Background checks on employees who are responsible for, or have access to, customer information,
- Dual control procedures and segregation of duties for employees who have access to customer information,
- Monitoring systems and procedures to detect and investigate suspicious activities, and
- Measures to protect customer information from destruction, loss or damage from fire, water damage, power or technological failures, or other environmental hazards.

These are only a few examples of the security measures you can take to protect customer information. The key is to identify the places where you're most vulnerable and to adopt measures that target those spots.

A good investment

In the end, the time and expense you put into an assessment of your security risks — and controls to minimize them — will be a rock-solid step toward protecting your customers and your relationship with them. Technology as revolutionary as what the banking industry has experienced in the last decade demands nothing less. 

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