

# Bank Notes

A timely information and idea statement

January/February 2012

## Critical strategy considerations for depository institutions in 2012

By: Jim Lamb

Lewis Carroll once made the astute remark, "If you don't know where you are going, any road will get you there." This maxim certainly holds true for our personal lives and maybe even for our business lives too. Success is achieved only when the path is clearly marked and the goal is well defined. Whether we're talking about people or companies, the most successful ones share the common characteristic of being good planners and executors.

This article is intended to refresh and crystallize the importance of developing a strategy—a business plan that will decisively improve the performance of your organization. First and foremost, take the time to develop a plan. As we come out of the challenges of 2007-2011, there are critical strategy considerations for financial institutions that should be explored and exploited in 2012 and beyond.

Over the last few years, we have seen deterioration in the political and economic climate affecting financial institutions. We have seen federal regulators define tougher standards that have affected all parts of an institution's structure and organization. We have seen higher capital requirements create challenges, while lending to qualified customers has become more daunting than ever. It has even become more difficult to find talented leadership, especially in operations. What's more, all financial institutions, regardless of size or capital structure, have been affected.

After all these momentous changes in the industry, financial institutions must ask themselves several questions:

- How will these watershed events affect our business?
- Does our business plan take account of these new market realities?
- Is our present plan adequate to meet the regulatory, market and competitive challenges of 2012?

January and February are good times to revisit your business plan. Consider using this period to bring it up to date. At a minimum, you should have plans developed for a one-year, three-year and five-year time horizon. Below are some important strategic planning issues that all financial plans should consider.

### The master plan – Major components

#### *Operational improvement*

Many financial institutions have been forced to reduce costs to improve earnings. Financial institutions should continue to search for ways to cut costs, while also striving to develop a culture of business process improvement. This process should be ongoing, rather than just temporary or in reaction to short-term financial conditions. Some of the ways to improve operational efficiencies are:

- *Spend analytics* – "Spend" is the common name for the organization's purchases. Most financial institutions have little experience in advanced procurement practices. Consider launching an initiative to evaluate such things as sourcing, pricing, alternatives and volume procured. A related initiative is Demand Management, a process for evaluating the costs, benefits and overall value of organizational purchases. The goal is to rationalize buying patterns and procurement requirements, and it should be a cross-departmental effort.
- *Shared services* – Many organizations today have multiple facilities and/or multiple companies. Financial institutions should continue to investigate ways to consolidate non-client facing functions across facilities or companies. Many internal processes could be aggregated, including accounting, accounts payable, payroll, human resources, internal audit, compliance, information technology (IT), item processing, marketing, loan administration, mortgage underwriting and credit analytics.
- *Marketing justification* – Marketing expenses have grown substantially over the years. Yet it's not always clear if marketing purchases are improving the bottom line. Many marketing programs focus on general branding and creative initiatives that have little direct connection to growth in sales or revenue. To address this, organizations should analyze each marketing campaign to see how it affects overall business, sales and customer satisfaction benchmarks. The litmus tests for determining the viability of any marketing program should be, "Does it lead to

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## FFIEC issues new guidance on Internet banking authentication

By: Suzanne Northington

Anyone who follows the Internet banking industry knows that fraud related to online account access has been on the upswing in recent years. So it's not surprising that the FFIEC (Federal Financial Institutions Examination Council) would issue a supplement to its original guidance on the subject of Internet banking security. In fact, many may wonder what took them so long. It's been nearly six years since the first document, *Authentication in an Internet Banking Environment*, was released in October 2005.

Since then, electronic banking has grown in volume, scale and features, while cybercrime targeting bank customers has become more sophisticated. These factors have increased risks for financial institutions and their customers, and substantial losses have resulted. These events underscore the critical need for more effective security to safeguard customer funds, reduce fraudulent account activity and prevent theft of sensitive customer information.

This may be what prompted the FFIEC (the federal entity that prescribes uniform standards for the federal examination of financial institutions) to issue the Supplement on June 28 of last year. The release does not contain any startlingly new information; rather, it generally affirms many of the issues from the 2005 release, while also providing additional insight into higher risk transaction authentication. The Supplement articulates its purpose is "to update the FFIEC member agencies' supervisory expectations regarding customer authentication, layered security, and other controls in the increasingly hostile online environment."

First of all, to understand what types of crimes the Supplement may be addressing, (although the Supplement itself does not discuss specific criminal activities) let's briefly review four classical fraud schemes perpetuated by online banking criminals:

- *Phishing* is generally considered the most serious threat. It involves sending emails purporting to be from the users' banks and enticing them to enter their personal

information on a phony website that is disguised as a legitimate bank site.

- *Trojan horses* are usually covert installations of malicious software that automatically install on the victims' hard drives when they click on a link or attachment in an email. The Trojan horse is able to capture their password and ID when they log on to a legitimate bank site.
- *Classical identity theft* involves the perpetrator posing as the account holder over the telephone or in person. He may already have stolen the victim's ID and password, but strong challenge questions and other measures can thwart this type of crime.
- *Over the shoulder scheme* is theft the old-fashioned way: by personal observation, such as an offender watching a user ("standing over his shoulder") make financial transactions on his computer and jotting down the user's confidential ID and password.

The Supplement deals with several types of bank security, including telephone banking (if the transactions are deemed high risk) and online banking systems by personal computer or mobile device. Special attention was given to the security needs of business and commercial accounts. The short list of these security measures is as follows:

- Enhanced risk assessments
- Layered security controls
- Fraud detection and monitoring
- Dual authorization
- Out of band transaction confirmation
- More effective authentication techniques
- Heightened education initiatives

To read more, go to: <http://mcgladrey.com/Bank-Notes/FFIEC-issues-new-guidance-on-internet-banking-authentication>

## Private banks may be permitted to stay private

By: Suzanne Northington

Privately-held banks should pay special attention to a bill currently under proposal in Congress. The bill is targeting the 500-shareholder rule, one of the key requirements for determining when a private company must begin filing 10-Qs and 10-Ks. It's a rule that has long marked the dividing line between private and public status for most private companies.

Under current law (part of the *Securities Exchange Act of 1934*), companies are subject to SEC reporting requirements after they pass the 500-shareholder limit. While bank holding companies file their 10-Qs and 10-Ks with the SEC, banks with more than 500-shareholders generally file with their primary banking regulator. The current law also requires them to

include any employee who receives stock as compensation in the 500-shareholder limit.

Now the *Private Company Flexibility and Growth Act* (H.R. 2167) could amend the statute by raising the threshold rule to 1,000 persons. The bill would also exclude persons who receive stock as part of an employee compensation plan from counting towards the threshold number. If the bill becomes law, it could mean more flexibility for private banks, allowing them to stay private longer and have more flexibility and control over their growth – at least for a time, until they too reach the 1,000 person limit.

Watch for breaking developments on this important legislation in early 2012. You can read the entire House bill [here](#).

## Case Study: Rapid operational assessment for a \$400 million financial institution

By: Suzanne Northington

### Project

This mid-sized Midwestern financial institution has faced economic challenges over the past few years. But at the time this case study was done, the economy was improving, and management expected that 2012 would provide fresh opportunities for growth. Especially promising were national growth trends that emerged in late 2011. Management expected these market trends to continue in 2012 and wanted to be ready for whatever new business opportunities came its way.

To ensure that the company could take full advantage of a stronger market, management needed to review and assess their entire operation. Having retrenched its staffing in recent years in response to lackluster demand, the company recognized that it may lack the capacity to ramp up operations quickly. Given the momentum of current trends, the institution determined it needed to get some quick answers.

## Pricing sources for determining fair value of investments

By: Suzanne Northington

The SEC staff has recently shown increasing interest in how companies are using pricing service information to determine the fair value of their investment securities. Third party pricing services are commonly used by financial institutions to estimate the fair value of their investment securities. The SEC staff is focused on securities that are not actively traded, as well as those for which there is no observable data upon which

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deeper market penetration and increased wallet share?" and "Did a particular marketing campaign increase auto loans, mortgages, credit/debit cards, deposits or other investments?"

- *Product management* – Who are the product managers? A common organizational problem is a lack of alignment and accountability in product management functions. Frequently, an organization will have certain employees carrying out such tasks as reviewing product financials, modifying product features, launching marketing plans and training personnel on origination and new accounts. However, accountability for product performance is often vague and undefined. For instance, if the annual budget indicates that auto loans will increase by 12 percent and after eight months, growth is only 6 percent, who will be accountable for insuring that campaigns focus on attaining the 12 percent target?
- *Business process improvement* – To root out inefficiencies in internal processes, organizations should track the performance of each process. IT is one function that can benefit significantly from performance tracking. Goals

### The challenge

Starting with a business plan that set down the higher goals for growth, management identified four fundamental questions:

- *Cost savings* – Where can we cut costs and use the savings to fund our growth?
- *Scalability* – Are our operations and processes fully scalable with the capacity to ramp up in response to higher demand?
- *Operational efficiencies* - How can we improve operational efficiencies and optimize our existing resources?
- *Member services* - How can we achieve the above goals while simultaneously improving and enhancing the services we provide for our members?

To read more, go to: <http://mcgladrey.com/Bank-Notes/Case-Study-Rapid-operational-assessment-for-a-400-million-financial-institution>

to estimate fair value (e.g., private-label mortgage backed securities, collateralized mortgage obligations, collateralized debt obligations). When an exchange traded price is not available, the pricing services are exercising a degree of discretion and judgment to reach an estimate.

To read more, go to: <http://mcgladrey.com/Bank-Notes/Pricing-sources-for-determining-fair-value-of-investments>

should be established for functional managers, as well as a baseline against which to measure their performance. These operational metrics can be used to help reduce costs and improve customer service. Metrics can also be used to identify non-value added tasks that can be earmarked for elimination. Examples of these tasks include excessive handling of documents, ineffective use of functions available in computer applications and superfluous, poorly managed meetings.

- *Technology enablement* –Technology can help financial institutions operate at optimal efficiency. Evaluate your technology platform and applications to determine what steps should be taken to improve security, cost effectiveness, process performance and product management. As one of the most expensive items in the budget, IT costs can be reduced by having network, applications and security procedures assessed periodically by an independent consultant.

To read more, go to: <http://mcgladrey.com/Bank-Notes/Critical-strategy-considerations-for-depository-institutions-in-2012>



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