November/December 2011

Bank Notes

A timely information and idea statement

Making the most out of SOX/FDICIA compliance

By: Ed Haidenthaller

It's hard to believe that the Sarbanes-Oxley Act (SOX) will be 10 years old in July 2012. As many companies will remember, those early years were pretty rough. The early adopters – those first companies earmarked for compliance– were given only until the end of 2004 to bring themselves into conformity with the law. While the requirement was clear, it wasn't so clear how they would accomplish this herculean feat in the short time span allowed.

So it wasn't surprising when word got out that some early adopters – including some brand-name Fortune 500 companies – were spending tens of millions of dollars in their attempts to meet the deadline. Equally unsurprising perhaps were the negative earnings' performances of many early adopters in the period between 2004 and 2007. Since the economy was robust during this period, it's no great leap to see a connection between the lackluster performances and the high costs of SOX compliance.

SOX for the banking industry

These woeful tales were widely reported in the business media and are now well-known. Much less well known is the fact that the banking industry had been dealing with equally burdensome regulations since the late 1980s. Long before Enron, WorldCom and Adelphia became household names, banks had their own version of SOX. It arose out of another financial crisis, the savings and loan (S&L) crisis of the late 1980s. In its aftermath, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) was passed.

FDICIA is similar to SOX (both deal with an entity's evaluation of control structures), but it has a slightly different focus. SOX deals with internal control structures and processes that influence creation of financial statements and financial reporting. FDICIA focuses on operating a financial institution in a "safe and sound" environment. This means that FDICIA can include issues and processes that do not directly impact financial statements, but most assuredly includes those that flow through to the financials. From a compliance perspective, financial institutions over $500 million in assets must comply with many of the provisions of FDICIA. When they cross the $1 billion in assets level, they must comply with all aspects of the regulations. Initial costs for compliance can dramatically erode profitability in the first few years.

Why the interest now?

But if these two laws have been around for so long, why is everyone talking about them now? Simply put, because economic times are tough. We all hear terms like "financial crisis", "economic downturn", "recession" and "double-dip recession", but the full implications of these terms are not always fully understood. What underlies them are unprecedented changes in the nation's financial and banking systems. The last four years have been some of the most difficult in recent memory. Since 2007 there has been a housing market crash, a downturn in the financial markets and a rash of bankruptcies. Some banks were acquired, while others were eliminated from the competitive landscape. There have also been 407 bank failures, both regulator assisted and unassisted transactions, many withdrawals of charters and the outright dissolution of many banking entities. Consider that at the beginning of 1985 (before the S&L crisis) there were over 14,000 commercial banks in the country. By the second quarter of 2011, there were only 6,327 commercial banks, a reduction of more than half, according to Federal Reserve Economic Data. For the banks left standing, they wonder, "What will happen next?"

More banks are falling under regulatory framework

Unfortunately, it appears that consolidation in the industry is not over. For a bank to survive, the conventional wisdom is that it needs over $500 million in assets. This realization seems to be causing small community banks to start looking around, wondering what they should do, trying to figure out if they will become a target themselves. Or, they may wonder if the best survival strategy would be to become an acquirer of others. Any of these events could potentially thrust a longstanding private bank into the public realm, something that would put them under the FDICIA and/or SOX regulatory framework.

Still other banks that were methodically growing through conservative small steps have been approached by regulators and asked to bid on portfolios or absorb their former competition through FDIC assisted transactions. These banks have doubled or tripled in size rather quickly, and when they surpass the designated asset levels, they are immediately put into a FDICIA regulatory framework and forced to meet the

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Fresh focus on IT – Preparing for a new regulatory phase

By: Loras Even

Like everything else in business, the focus of regulators changes from time to time. For example, in response to large scale hacking and security breaches in the early 2000s, examiners turned their attention to Information Technology (IT) security issues. In response, many banks invested heavily in IT security during those years, only to see regulator interest fall by the wayside after the calamitous financial events of late 2008.

That led to a new phase, one in which examiners put IT on the back burner so they could focus on "standard" financial issues that were seen as pivotal to banks' very survival. Most enforcement actions during this phase were related to safety and soundness, with regulators asking such basic questions as "is the bank well capitalized, is loan loss allowance adequate, does it have sufficient liquidity and is it making safe loans?" In view of the large number of bank failures in recent years (408 since the start of 2008), this shift in focus was both understandable and predictable.

The pendulum swings back

Now, after three years of focus on the fundamentals, banks are probably wondering when regulators are going to come back to IT. After all, some of the "drama" has died down in the financial markets, leading many bankers to expect the regulatory pendulum to shift back. Well, that is exactly what's happening. In fact, the trend back to IT seems to be well underway. The easing of recessionary concerns and political pressures are just two of the reasons why regulators are feeling freer to focus again on IT. (It's also possible that a few high-profile security breaches this year gave them added motivation.) This doesn't mean that regulators aren't looking at the core financial issues, just that regulators are renewing their interest in IT security.

So maybe it's time for banks to gear up for this new regulatory focus. Gearing up means making sure the bank is addressing the issues of concern to regulators and beefing up security measures before the examiner knocks on the door. Here's a list of the top five IT security issues of interest to regulators:

- **Internet authentication requirements**

  This issue is in response to the growing volume of hacking and privacy breaches of online customer accounts, and the resultant fraud and theft. A primary cause of the problem is believed to be the weakness of user authentication measures, especially password structure and verification. At some banks, customers are not required to change their passwords periodically, and many are allowed to use "weak" passwords, such as their own name, short words (cat) or number series (1234) that can be easily discovered by hackers. Ways to address these issues are to require periodic changing of the password and enforcing strong passwords that require both upper and lowercase characters and a letter/number combination at minimum. But not all banks as yet require their customers to adopt these measures.

To read more, go to: http://mcgladrey.com/Bank-Notes/Fresh-focus-on-IT-Preparing-for-a-new-regulatory-phase

Taxing earnings and profits in a bank merger

By: Rick Bailine

When two banks merge and shareholders of the acquired bank receive "boot" (taxable consideration), how does one measure earnings and profits (E&P) to determine if the boot may be taxed as a dividend or as capital gains income? This is a common question that arises after bank mergers, yet the answer may not be entirely clear to financial managers at either institution. Because banks are highly regulated, the issue is important for both tax and regulatory reasons. So let's look at how this problem might play out by considering the following two mergers:

Merger #1

BHC, a bank holding company, owns all the stock of Bank X and Bank Y. Each bank has E&P of $250. The fair market value (FMV) of the Bank X stock is $1,000 and the FMV of the Bank Y stock is $1,500. To simplify business matters, BHC would like to merge Bank X into Bank Y, with Bank Y as the surviving corporation. In that merger, BHC (as the sole shareholder of Bank X) will be paid $500 of Bank Y stock and $500 in cash.

Merger #2

Q Financial, a bank holding company, owns all the stock of Bank Q. B, an individual unrelated to Q Financial, owns all the stock of Bank Z. Bank Q and Bank Z each has $250 of E&P. The FMV of Q Financial stock is $1,000, and the FMV of Bank Z stock is $2,000. For bona fide business reasons, Q Financial and B have agreed to combine their respective banks via a merger of Bank Z into Bank Q, with Bank Q as the surviving corporation. In the merger, B (as the sole shareholder of Bank Z) will be paid $1,500 of Q Financial stock and $500 in cash.

In both Merger #1 and Merger #2 there is a corporate reorganization, as defined in section 368(a)(1)(A) of the Internal Revenue Code (IRC). In each merger, the shareholder of the acquired bank will receive not only stock of the acquiring bank (or stock of the parent of the acquiring bank), but boot (i.e. the cash) as well. Clearly, under IRC section 354, if the shareholder of the acquired bank receives solely stock of the acquiring bank (or its parent), that shareholder is not taxed. But just as clearly under IRC section 356, when boot is present, the shareholder will be taxed, generally to the extent of the boot received.

To read more, go to: http://mcgladrey.com/Bank-Notes/Taxing-earnings-and-profits-in-a-bank-merger

Managing risk in today's regulatory environment

By: John Brackett

Today's banking institutions are facing a heightened regulatory environment. In response to recent financial crises, government bodies have stepped up scrutiny of banks' risk management practices. Regulators are asking more and more questions about their Enterprise Risk Management (ERM) systems, and whether supervisory frameworks are adequate. Debt rating agencies have also increased their examination of banks' risk management processes. Even small community banks, historically unaccustomed to fielding such questions, are receiving increased scrutiny.

As a result, banks can no longer afford to view ERM as an option. It is increasingly becoming a necessity, regardless of bank size. By definition, banks are highly complex operations operating within equally complex capital markets. The more complex the interaction of parts within the organization, the stronger the need for effective risk practices that can identify problems in advance. The interdependency of these parts means that one weak link could unravel the entire structure. This may explain how inadequate risk management practices can lead to systemic failure of the institution, and given the deep integration of banks within the larger financial markets framework, to dire consequences for the economy as a whole.

Given these factors, banks should revisit their ERM framework periodically to assess whether it has the capacity to meet the heightened regulatory standards. Yet as one stares at a risk management plan on paper, it's not always easy to assess the organization's tolerance for risk. Would it pass a compliance examination? Has it considered the possibility of unforeseen events? And is its risk framework really integrated on an enterprise-wide basis?

A focus on corporate governance

The starting point of a bank's ERM initiative should be a pledge of commitment to risk management by the board and top-tier executives. The actions of company leaders are critical in establishing the ethical framework of the organization. "Tone-at-the-top" tends to have a trickle-down effect throughout the organization, and should be a major focus for any risk management process. Additionally, steps should be taken to fully integrate the "tone" into all corporate governance policies and strategies. This process is aided by the establishment of a risk committee or chief risk officer who can serve as the coordinator of all risk activities in the bank.

To read more, go to: http://mcgladrey.com/Bank-Notes/Managing-risk-in-todays-regulatory-environment

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rigorous standards — often well before they have had time to prepare for it with new control systems.

Whatever your bank's reason for falling under the FDICIA/ SOX umbrellas, one thing is clear: You don't have to repeat the experiences of those early SOX adopters, especially in terms of compliance costs. Much has been learned since those days, and "best practices" have been developed to make the transition much easier than it once was. All of this works to the advantage of those banks just coming under FDICIA/ SOX frameworks.

Below we will share some insights and tips to help you along the road to compliance. These tips can also help those banks who are not new to compliance, but who could use some added "inspiration" (i.e., ways to help make the compliance process more efficient and cost effective).

Tip #1 – Learn from your predecessors

Remember that others have walked this rocky path before you. It is not plagiarism or transgression of the unwritten law to learn from your peers and not make the same mistakes they did.

Here are some lessons garnered from SOX veterans:

- Give yourself plenty of time. Do not underestimate the time and resources your company will need. Allow plenty of time to identify risks in the controls processes and to find ways to streamline them. Your project schedule should include ample time for current staff to document their day-to-day tasks and prepare required information.
- Educate yourself. Go to seminars, read periodicals, talk to experts and use whatever resources you can find to learn about ways to minimize the impact of compliance. One thing learned from early adopters is they typically overdid control documentation and testing. This is a good lesson to draw upon, since overkill translates into higher compliance costs.
- Coordinate your efforts. SOX compliance requires that many entities orchestrate their activities in one process. All entities should be in agreement as to approach, method, framework and templates. Groups to be included in the dialogue are line employees in multiple departments, audit committee members, outside auditors, consultants and internal audit staff.

Tip #2 – Avoid heavy lifting

Use the power of leverage to reduce the workload. Take full advantage of what has already been done at your bank. Although this may sound like common sense, too many companies "reinvent the wheel" by creating new documentation when they already have policies, procedures and operating guides in place. All of these can be used to create SOX documentation. The only caveat to keep in mind is that some documents may be too detailed, or they may be written from the wrong perspective. If you decide to use them for SOX purposes, be sure they cover the basic process steps and are relevant for purposes of control and risk identification.

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111 Veterans Memorial Blvd., Suite 600
Metairie, LA 70005

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For additional copies or change of address, contact LaPorte CPAs & Business Advisors. For more information, contact Leslie Paull, at (504) 835-5522 or e-mail her at lpaull@laporte.com. Visit our Web site at www.laporte.com.

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Printed in U.S.A.