January/February 2013

Financial Institutions Insights

A timely information and idea statement

Bank Notes has become Financial Institution Insights. The renaming of our bimonthly newsletter reflects our continued commitment to banks and savings institutions, trust organizations, credit unions, mortgage companies, finance and leasing companies, financial advisers and partnerships.

Assessing the risks of third-party providers

By Loras Even and Carla Brinker

Outsourcing is an increasingly popular and cost-effective practice among financial institutions. Third-party vendors offer short-term access to specialty services that would otherwise be cost-prohibitive if done internally. They range from noncritical personnel like rug installers, plumbers and editorial consultants, to highly critical providers like network support staff, data processors and website developers. There's also been a clear trend toward offshore servicing of technology providers for reasons of cost. Offering a clear financial advantage, outsourcing has grown substantially in recent years, even for the most critical tasks upon which the financial institution's operation depends.

Yet the use of third-party vendors also opens up a vast number of potential risks for the financial institution, the most significant of which are legal, financial, compliance, operational and reputational. So while a financial institution can transfer a task to a third party, it can never, at any time, transfer responsibility or liability to that party.

Easy to understand, hard to achieve

All financial institutions understand these clear and unambiguous precepts. They know that outsourcing of critical tasks requires a concurrent focus on vendor management, including regular vetting, monitoring and tracking. Yet at some financial institutions, vendor management practices have not caught up with the reality of today's outsourcing risks. Vendor tracking procedures are still rather elementary and lacking at some institutions. That's probably because third-party risks have evolved much faster (think of the recent spate of bank hacking episodes) than have the commensurate vendor risk management programs.

Thus, the challenge for financial institutions is to restructure their vendor management programs to meet the ever evolving risks facing both them and their third-party vendors.

Hackers and other corporate thieves are skilled at finding the vulnerabilities of commercial enterprises and have apparently recognized that third-party vendors represent a weak spot for many organizations. For hackers, these vendors, which may be physically or electronically holding a financial institution's sensitive data, represent a golden opportunity for thievery of all types.

Compliance poses a major risk

In addition to the growing sophistication of hackers, other trends support the need for more aggressive vendor management. One involves the new government regulations that increase requirements for customer data privacy and security. Regulators have made clear that they want financial institutions to engage in proactive and ongoing vendor management. The Federal Financial Institution Examination Council (FFIEC), The Gramm–Leach–Bliley Act of 1999 and the Federal Deposit Insurance Corporation (FDIC) each has significant requirements and penalties involving protection of consumer data. As a consequence, government examiners can be expected to ask more aggressive questions in the future, making third-party regulatory compliance all the more critical.

What is a critical vendor?

Financial institutions typically have many third-party vendors. But which of these are critical vendors? Not all vendors need to be managed for compliance or legal risks. The vendor that maintains the water coolers doesn't carry the same risk to the financial institution as does its network support provider. Yet when facing a database of many vendors, many financial institutions struggle to identify which of them are critical to their operation, and thus need to be risk-rated and risk-managed more effectively.

To read more, go to: http://mcgladrey.com/Financial-Institution-Insights/Assessing-the-risks-of-third-party-providers

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Changes in tax rules governing tangible assets and repairs

By Mike Metz Partner, National Tax McGladrey LLP

The federal tax rules governing whether a financial institution can deduct the costs to remodel or refresh a branch are changing. The revised rules will affect any business that acquires, produces or improves tangible property. The temporary tax regulations issued in late 2011 defined when taxpayers need to capitalize costs to acquire, maintain or improve fixed assets. Interestingly, we have found that many financial institutions are capitalizing more costs than these rules require.

It is expected that most financial institutions with fixed assets may need to file at least two Forms 3115, Application for Change in Accounting Method, to change their methods of accounting to comply with these rules under the current method change guidance (see Rev. Proc. 2012-19 and Rev. Proc. 2012-20). Making such accounting method changes can affect fixed asset software systems and processes to capture, maintain and account for information. Due to the broad applicability of and substantive changes made to the rules, the IRS has generally ceased exam activity with respect to this area for current tax years.

On Nov. 20, 2012, the IRS and Treasury Department (the federal government) released Notice 2012-73, announcing that they anticipate issuing final regulations in 2013. Also announced was an intended delay in the effective date of the regulations until taxable years beginning on or after Jan. 1, 2014. Additionally, in response to numerous written comments received since the publication of the temporary regulations, as well as oral testimony received at the public hearing held in May 2012, the notice provides that the following areas of the temporary regulations may be revised, and in certain cases simplified:

- Oversight
- De minimis rule
- Dispositions
- Safe harbor for routine maintenance

In addition, the revisions may provide relief for small businesses.

On Dec. 14, 2012, the federal government officially amended the effective date of the regulations for the two-year delay (until tax years beginning on or after Jan. 1, 2014) and provided rules for the optional early adoption of the temporary regulations. The preamble to the technical amendments provides that taxpayers opting for early adoption of sections of the temporary regulations may continue to rely on the automatic consent provisions provided in Rev. Proc. 2012-19 and Rev. Proc. 2012-20.

The two-year delay of the effective date of the final regulations is welcome relief for many financial institutions. It provides a great opportunity for taxpayers to optimally plan to early adopt sections of the temporary regulations and selectively file automatic method change requests for taxable years beginning after Dec. 31, 2011, depending on their facts, circumstances and tax planning objectives. Thus, it is imperative that every financial institution takes time now to determine how the rules discussed below may affect them, as well as to determine which sections of the temporary regulations to go ahead and implement and when.

To read more, go to: http://mcgladrey.com/Tax-Services/Changes-in-tax-rules-governing-tangible-assets-and-repairs

Keeping up with MERS – New membership rules go into effect on March 18, 2013

By Joe Benfatti

Any bank or credit union that is a member of Mortgage Electronic Registration System, Inc. (MERS) should pay close attention to recent changes in its rules and compliance requirements. Since 2011, MERs has launched a number of initiatives to clarify and strengthen its business practices and member rules. No doubt, these changes have been in response to the groundswell of court rulings and government consent decrees that have challenged its business model in recent years. The objective of the changes is to reduce the potential legal and compliance risks facing MERS and its members. Yet, as of early 2013, there's no clear sign that these cases are abating or that the debate about MERS has been settled. So given the unresolved issues, MERS members should monitor events closely, and brace for the possibility of more refinements and changes to MERS compliance requirements

For now, member banks and credit unions are advised to review their procedures and practices against recent MERS announcements and evaluate whether they are in compliance.

One important requirement is for the submission of an annual report attesting to compliance with quality assurance standards, along with an updated quality assurance plan. Some member banks and credit unions, however, may not be fully aware of recent rule updates; consequently, they may not have planned for the changes, budgeted for it or implemented quality control measures. Small organizations may also lack the staffing needed to support the requirements.

Even the largest organizations may find themselves in a position of noncompliance with some of the more technical MERS requirements. The best way to ensure compliance is to incorporate compliance monitoring into the bank's everyday loan origination and servicing practices and procedures; these should track compliance at every step of the process, as well as generate an audit trail that can identify any deviations.

To read more, go to: http://mcgladrey.com/Financial-Institution-Insights/Keeping-up-with-MERS

Creating a culture of integrity is the cornerstone of fraud prevention

By Mike Mossel Principal, McGladrey LLP

The implications of fraud not only can impact a credit union's operations; they also extend outside the organization, damaging its position within the market and community. The cost of fraud is more than monetary; it's also lost productivity, sullied reputations and damaged member relationships.

This white paper addresses where to start in developing an effective anti-fraud program – by creating and nurturing a culture of integrity.

Download the white paper

FASB proposes new credit impairment model

The Financial Accounting Standards Board (FASB) has issued a proposed Accounting Standards Update (ASU), Financial Instruments—Credit Losses (Subtopic 825-15), which proposes a new accounting model intended to require more timely recognition of expected credit losses on financial assets that are not accounted for at fair value through net income. The proposed guidance would apply to all entities that hold financial assets exposed to credit risk, including loan, lease, reinsurance and trade receivables, debt securities and commitments to lend. The major provisions of the proposed ASU are briefly summarized below and discussed further in our white paper, Credit impairment – A long and winding road.

The FASB's proposed model would utilize a single "expected credit loss" measurement approach for the recognition of credit losses on all financial assets subject to the guidance. The proposed model would replace the multiple existing impairment models in U.S. generally accepted accounting principles, some of which require that a loss be "incurred" before it is recognized. Under the proposal, management would be required to estimate the cash flows that it does not expect to collect using all available information, including historical experience and reasonable and supportable forecasts about the future. The proposed ASU specifically states that an estimate of expected credit losses would neither be a "worst-case" nor a "best-case" scenario. An entity would be prohibited from estimating expected credit losses solely on the basis of the most likely outcome. Certain approaches employed in current practice may be consistent with this aspect of the proposed guidance if they consider historical loss data on a population of assets, some of which ultimately incurred a credit loss and some of which incurred no credit loss.

The FASB anticipates that expected credit loss estimates often would be measured for pools of similar asset types using credit risk ratings as of the balance-sheet date. As a result, entities could leverage their existing internal credit risk management tools and systems to implement the proposed model.

Under the proposed model, the credit deterioration (or improvement) reflected in the income statement would include changes in the estimate of expected credit losses resulting from, but not limited to, changes in the credit risk of assets held by the entity, changes in historical loss experience for assets like those held at the reporting date, changes in current conditions and changes in reasonable and supportable forecasts about the future. As a result, the balance sheet would reflect the current estimate of expected credit losses at the reporting date (the allowance for credit losses) and the income statement would reflect the effects of credit deterioration (or improvement) that has taken place during the period.

The proposed ASU does not specify an effective date, which the FASB indicated will be established with the issuance of the final ASU. Adoption of the proposed guidance would be accomplished through a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. The FASB is soliciting comments on the exposure draft through April 30, 2013.

Eight common mortgage loan origination fraud schemes to watch for today

By Al Kohl Manager, McGladrey LLP

Despite closer scrutiny by regulators and new rules and laws put into effect after the mortgage market meltdown, and even with the reduction in mortgage activity, mortgage loan origination fraud continues to proliferate and remains on the FBI's list of priority white collar crimes. The eight common fraud schemes discussed in this white paper are:

- Inflated income schemes
- Silent second mortgage
- Undisclosed side deals with lenders
- Appraisal schemes
- Cash back schemes
- Undisclosed sources of down payments
- Forgiven or covered closing cost schemes
- Falsified closing date schemes

Read McGladrey's white paper to learn how these schemes work – and how to combat them.

Download the white paper

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