Deposit strategy

A disciplined approach is absolutely essential

Institutions need to evaluate deposit-gathering and pricing strategies to ensure that they are economically and financially sound, providing adequate funding when needed, a deposit strategist warns.

In today's difficult operating environment, such strategies must take into account—and contend with the continuing impacts from—very low interest rates, a glut of deposits, low loan demand, and fierce competition from other depository institutions.

The issue really goes beyond deposit pricing—it involves implementation of an effective future-oriented, core-funding growth strategy.

Deposit strategist Matt Lephardt, vice-president and head of funding products, M&I Capital Markets, Milwaukee, Wis., pointed out that while acquiring new accounts is important, institutions must also be sure to avoid setting irrational deposit prices for purely competitive reasons.

Key strategies

He recommended these strategies:

- Focus on acquiring new accounts.
- Utilize checking-account relationships to cross-sell customers.
- Leverage such relationships to generate non-interest income.
- Maintain discipline to avoid pitfalls of competitive pricing.
- Reward staffers who bring in lasting long-term core deposits.
- Use brokered deposits to enhance liquidity for the long term.

“The strategy really is to work to cross-sell your customers and get them in your deposit products—but not to overpay for ‘core deposits’ that
Section 404 (b)
SEC says existing requirements to comply must be maintained

The SEC recently published the results of a study and related recommendations concerning the application of Sarbanes-Oxley Section 404 (b) for institutions whose market capitalization is between $75 million and $250 million.

In the 113-page study, published April 22, the SEC staff concluded that for issuers with public float of $75 million to $250 million, the existing requirements to comply with auditor attestation provisions should be maintained, and no new exemptions should be granted.

SOX Section 404 (b), known as the “auditor attestation” mandate, requires independent auditors to attest to management’s assessment of the effectiveness of its internal control over financial reporting. The study did not address the mandate in Section 404 (a) for management to report on the effectiveness of such controls.

A provision of the Dodd-Frank Act regulatory-reform legislation required the SEC to conduct the study, in order to determine how it could reduce the burden of companies when complying with SOX 404 (b), while at the same time maintaining investor protection.

In the study, the SEC pointed out that the costs and burdens of complying with Section 404 (b) have declined over time—particularly in response to regulatory reforms in 404 mandates that were made in 2007—and that eliminating them would not justify the “loss of investor protections and benefits to issuers.”

In addition, it noted that investors generally view the external auditor’s attestation as beneficial—and that financial reporting is more reliable when the auditor is involved with assessments of internal control over financial reporting.

Further, the SEC made clear that it does not recommend an approach allowing an issuer to “opt out” of Section 404 (b) compliance, an option sometimes proposed in previous studies of SOX. The Dodd-Frank Act already exempted smaller companies with a market capitalization of less than $75 million from the section 404 (b) requirement.

Reacting to the study’s results and recommendations, the Center for Audit Quality (CAQ) said that it was pleased that the study recommends the retention of Section 404 (b). “We hope this study will effectively discourage further discussions around ways to dilute the investor protections contained in Sarbanes-Oxley,” the CAQ said.

In its major recommendations, the SEC study encouraged auditors to continue refining their methodologies to support a top-down, risk-based approach when auditing internal controls over financial reporting. For example, it said that expected new requirements for the COSO internal control framework should lead to greater efficiencies in conducting an audit under 404 (b).

The SEC noted that the COSO committee is involved in a current project to update its internal control framework for release in 2012. The current form of the integrated framework is widely accepted by organizations as a standard for evaluating internal control related to SOX compliance.

“The (SEC) staff believes that this project can contribute to effective and efficient audits by providing management and auditors with improved internal control guidance that reflects today’s operating and regulatory environment and by allowing constituent groups to share information on improvements that can be made that enhance the ability to design, implement and assess internal controls,” it said.

You may review further details in the SOX/FDICIA section of the News Archive on the FMS Web site at www.fmsinc.org.
Deferred tax assets

Examiners scrutinizing for possible write-downs, capital impact

Examiners have begun closely scrutinizing the expected future tax benefits related to institutions’ deferred tax assets on their balance sheets, an audit specialist warns.

A growing number of small institutions, hurt by the financial crisis in the last few years, could be forced to write down the value of their deferred tax assets. Such institutions are at risk of facing losses when the tax-related assets decline in value and hurt the institution’s capital.

“Typically, most community banks that have been making or reporting net income for a certain period of time will tend to have a net deferred tax asset on their books,” says Jyothi Manohar, director of financial institution services at McGladrey & Pullen, LLP, Blue Bell, Pa.

“Up until two or three years ago, nobody really paid attention to the deferred tax assets,” Manohar explained. As long as the expectation was that the institution was going to continue to earn income, deferred tax assets could be supported.

Credit losses

“But now, because the current credit losses and investment other-than-temporary-impairment losses have hit the balance sheet so heavily for many community banks over the last couple of years, the net income number has changed to a net-loss number,” she said.

As a result, the value of deferred tax assets needs to be evaluated, just like any asset on the balance sheet. But the valuation process is not cut and dried—it involves subjectivity. “There’s a lot of judgment involved with it in much the same way that we go about evaluating the adequacy of the allowance for loan losses,” Manohar said.

Nonetheless, particularly when an institution has started to report net losses, it’s essential to determine whether a deferred tax asset can be supported on the balance sheet. “Can it be carried at 100% of the value, or do we need to apply some kind of a valuation allowance against it?” she said. “That’s been the dilemma.”

To hold the assets, institutions must make forecasts over how much profit they will earn in the future and a reasonable judgment concerning the likelihood that such a tax difference may be realized.

“What that means is that if the worksheet brings the institution to a conclusion that a certain portion of their deferred tax asset is going to be disallowed, then it would have a direct impact on the regulatory capital issues that are getting reported.”

Jyothi Manohar,
Director of Financial Institution Services
McGladrey & Pullen, LLP
Blue Bell, Pa.

Reductions in future earnings forecasts, or any flumming over the complex rules governing the assets, can trigger write-downs. So, in cases where the carrying value of tax assets has changed, the institution may need to do a write-down, or in certain cases a restatement of financial results from previous years.

The main challenge for institutions is to earn enough to justify the deferred tax assets, thus avoiding impairments.

Still another challenge, regulators are closely reviewing data on deferred tax assets in quarterly call-report worksheets.

Among other things, they are evaluating whether a particular institution must have any portion of its deferred tax asset disallowed for regulatory capital purposes. “What that means is that if the worksheet brings the institution to a conclusion that a certain portion of their deferred tax asset is going to be disallowed, then it would have a direct impact on the regulatory capital issues that are getting reported,” she said. “That’s a critical point.”

As a result, institutions cannot afford to make the mistake of evaluating deferred tax assets only when auditors or safety-and-soundness examiners come out, she said. “They should be looking at their deferred tax assets and taking a hard look at the worksheet in the call report when they do the quarterly call-report filing.”

Quarterly basis

She stressed that it would make sense for bankers to pay attention to the deferred tax-asset valuation on a quarterly basis. “And certainly, from a GAAP standpoint, if they have cumulative net losses for three consecutive periods, they absolutely have to do an evaluation,” she said.

Bottom line: Manohar recommends that if an institution has had net losses for two consecutive years and is likely to have a third year of losses, “they should start thinking about whether they will have to have a valuation allowance on their deferred tax asset.”

In addition, it’s essential to pay close attention to the call report worksheet for the deferred tax asset, and make sure that none of it is getting disallowed. “So that way, when you come to year end, or when you head towards a safety and soundness exam, you’re not caught by surprise if a portion of your deferred tax asset, or all of it, has to be written off,” she said.

FMS members are advised to consult closely with their auditors on how to address deferred tax assets, including any issues that arise in connection with preparation of financial statements.

You also may review further developments concerning these issues in the “taxes” section of the Industry News archive on the FMS web site at www.fmsinc.org.

FMU
end up acting non-core because they are so rate-sensitive that you don’t really have any other relationships with that customer,” Lephardt said.

Given the large glut of deposits at institutions, he noted there are some reservations about the long-term “stickiness” of the dollars sitting in accounts at the short end of the yield curve, earning very low rates. “A lot of folks aren’t locking up CDs and going out longer—they’re keeping their money in savings and checking accounts,” Lephardt pointed out.

Such customers may be waiting to move their money back into other investments, including equities or other types of mutual funds, or simply to start spending their money and “re-leverage up again,” he added. “You see that in general across the economy—until the American consumer really starts spending again, you’re not going to see a pickup.”

Deposit glut

There is also concern that a significant portion of the deposit glut may be held by customers who are rate-sensitive, and thus are prone to seek the highest yield, moving their deposits around among institutions.

“For some sort of rate move, they are going to go to your competitor across the street, for 10, 15, or 25 basis points of additional interest,” Lephardt warned.

As a result, he stressed that overpaying for deposits of rate-sensitive customers does not necessarily benefit the institution. “The benefit of the bank is to get the most stable, lowest cost (core) deposits to fund their loan books,” he noted. For example, this can be accomplished by obtaining transactional demand-deposit accounts, or through wholesale funding such as the brokered deposit market.

“But overpaying for the in-market deposit, I think, ultimately leads to compressed net interest margins—lower earnings for the bank,” he said. “I don’t think that ultimately is a good, long-term sustainable strategy.”

Given all these challenges, he recommends that institutions follow a combined strategy of focusing on acquiring new checking (transaction) accounts and cross-selling the customers of those accounts in order to generate increased non-interest income that will supplement a softened net interest margin.

There is concern that a significant portion of the deposit glut may be held by customers who are rate-sensitive, and thus are prone to seek the highest yield, moving their deposits around among institutions.

Matt Lephardt, Vice-president and Head of Funding Products M&I Capital Markets Milwaukee, Wis.

What institutions should be seeking is the core checking account, which provides an opportunity for obtaining overdraft fees and interchange income. Also, from a relationship standpoint, there is a much greater cross-sell opportunity with checking accounts than with other deposit instruments, since the institution has access to the customer’s information, he said.

When a new customer comes in the door, attracted to a higher-yield money market account, the next step is to get that single-service customer and grab hold of that entire household of business, Lephardt said.

This might include products such as checking and credit card business, as well as consumer and home loans, all of which can bring in additional fee revenues. The total cross-sell effort should be aimed at the entire household relationship, in order to obtain different generations of customers for the institution. “Really become full-service to that customer so that you’re not just over-paying and having a drag on your bank for this high-cost deposit,” he said.

It’s essential to draw in core deposits at levels that are not destructive to capital and net interest margin, while still balancing out the regulatory need to show strength in core deposits and core deposit growth, he explained.

As part of the process, institutions need to assess whether their current liquidity level represents core deposits that will be there for the long term. For example, if an institution is simply paying up for money market deposits that will leave the institution for 10 to 20 basis points more elsewhere, that’s not a core deposit.

Disciplined approach

Taking a highly disciplined approach is necessary for ensuring long-term deposits. While there is certainly a customer-service component that’s part of this, it’s important to avoid the pitfalls of the “best customer syndrome,” Lephardt said.

For example, at many institutions, if a customer buys a five-year CD but later asks to get out of it, that person may not be charged a pre-payment penalty, or may only be charged a minimal fee if considered a “good customer,” he said. “That’s a direct in-market deposit that I considered core, but all of a sudden it became very volatile.”

Such situations should be avoided by “getting some good controls and strategies around that sort of (customer) behavior.” When proper controls for deposit products are in place, this ensures that staffers will take a disciplined approach for charging fees if the customer’s behavior would cause the institution to lose money. “Focus on that behavior and make sure that your deposits, especially term deposits, become core and do stay in place,” he advised.

As another alternative, institutions also can look for reliable wholesale funding, such as brokered deposits that include a contract guarantee that such funding will be available for the entire term. These deposits also can be locked in as a hedge against changing interest rates, going forward.

For example, although rates have continued on page 7
their fundamental role in the economy as intermediaries of credit to businesses and other creditworthy borrowers, this policy is often neglected by examiners in the field—especially in regions most severely affected by the recession.

Field examiners are second-guessing bankers and independent professional appraisers by demanding unreasonably aggressive write-downs and reclassifications of viable commercial real estate loans and other assets, he said.

“The misplaced zeal of these examiners is having a chilling effect on lending,” he said. “Good loan opportunities are passed over for fear of examiner write-down and the resulting loss of income and capital.”

**Fewer resources**

Such regulation has a disproportionate impact on smaller banks, compared to large institutions, since they have fewer resources to dedicate to compliance. The Dodd-Frank Act will cause a significantly greater compliance burden for community banks, although its full impact won’t be known for years, he warned.

“By a wide margin, the most troubling aspect of the Dodd-Frank Act is the debit interchange, or ‘Durbin,’ amendment,” he said. Despite the statutory exemption for institutions with less than $10 billion assets, he said that small institutions cannot be effectively carved out.

“To use my bank as an example, in 2010 we had about $2,500 debit cards outstanding and our profit for the year was approximately $132,000 pre-tax,” he said. “If the Federal Reserve proposal goes into effect, I estimate that we could lose, based upon the lowest proposed interchange rate, approximately $237,000 per year on our debit card program—lost income that we would have to make up through higher fees on our products and services.”

Testifying on behalf of the Ohio Bankers League, Paul Reed, president and CEO at Farmers Bank and Savings Co., Pomeroy, Ohio, said that the typical banking exam today sometimes tends to focus on form over substance. “Too little in exams really deals with what is most important to my community,” Reed said.

“We have evolved a system that is safest for regulators,” he added, but the goal really should be one that is safer for the communities served.

As an example, he cited his last exam, where the regulator decided to downgrade a loan to a small business that had been a long-time customer of the bank. “The business was troubled, but we were paying close attention and working closely with the business to try to help it survive—we had already taken steps to fully protect the bank, and the customer was making payments,” he said.

**“Good loan opportunities are passed over for fear of examiner write-down and the resulting loss of income and capital.”**

William Loving, Jr., President and CEO Pendleton Community Bank Franklin, West Va.

Tommy Whittaker, president and CEO at The Farmers Bank, a $560-million-asset institution in Portland, Tenn., said he is concerned that the current community bank model will collapse under the massive weight of new rules and regulations.

“Combined with hundreds of new regulations expected from the Dodd-Frank Act, these pressures are slowly but surely strangling traditional community banks, handicapping our ability to meet the credit needs of our communities,” said Whittaker, who testified on behalf of the ABA.

Managing a mountain of regulations will be a significant challenge, he said. “The median-sized bank has only 37 employees—for them, and for banks like mine, this burden will be overwhelming.”

He stressed that historically, the cost of regulatory compliance as a share of operating expenses is two-and-a-half times greater for small institutions than for large banks. Also, such compliance rules create more pressure to hire additional compliance staff, not customer-facing staff.

“The consequences are real—costs are rising, access to capital is limited, and revenue sources have been severely cut,” he said. Without quick and bold action to relieve regulatory burden, the industry will witness a major contraction of the banking industry, with a thousand banks or more disappearing from communities all across the nation over the next few years, he warned.

“An individual regulation may not seem oppressive, but the cumulative impact of all the new rules plus the revisions of existing regulations is oppressive,” he added.

Sandra Thompson, FDIC director of risk management supervision, pointed out that at the end of 2010, there were 874 fewer FDIC insured institutions with assets under $1 billion than at the end of 2007, due to continuing consolidation and bank failures.

“The most important challenge facing community banks at present is improving their operating performance amid the lingering effects of the financial crisis and recession,” Thompson said.

Community banks overall earned $4.7 billion in 2010, versus a net loss reported for 2009. Fewer institutions reported individual annual losses in 2010 than in the previous year, and two-thirds of community banks had earnings improvement in 2010, versus only 40% in 2009, Thompson said.

There are still many troubled assets, and charge-offs remain high. “Asset quality is not recovering as quickly at community banks as at larger banks,” she added. The ratio of noncurrent loans to total loans for community banks—that is, institutions with under $1 billion assets—fell very slightly during the fourth quarter to 3.46%, and was flat versus a year ago.

The average return on assets (ROA) for community banks in 2010 was 0.33%, an improvement over the prior year’s loss, but only half of the overall banking industry’s ROA of 0.66%—indicating that community bank performance is below that of larger banks, she said.

As for onerous regulations, she noted that the FDIC is considering how Dodd-Frank provisions could impact community banks. “For example, we
### Regulatory and Accounting Checklist

*These proposals may be accessed through the FMS Web site at www.fmsinc.org. Go to the Members Only section and follow the Regulations/Proposals link for direct access to the following documents.*

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<th>Category</th>
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<td><strong>Financial Market Utilities</strong></td>
<td>Comments due: May 19, 2011 FED: The Fed proposed rules that would establish risk-management standards governing the operations related to the payment, clearing and settlement activities of designated financial market utilities, based on provisions of the Dodd-Frank Act.</td>
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<td><strong>Interest Rate Risk</strong></td>
<td>Comments due: May 23, 2011 NCUA: The NCUA is proposing changes in regulations to require federally insured credit unions to have a written policy addressing IRR, and an effective IRR program as part of their asset liability management.</td>
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<td><strong>Orderly Liquidation Authority</strong></td>
<td>Comments due: May 23, 2011 FDIC: The FDIC issued an NPR to further clarify the application of the orderly liquidation authority under the Dodd-Frank Act. The proposal would establish a framework for priority payment of creditors.</td>
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<td><strong>Incentive-based Compensation Arrangements</strong></td>
<td>Comments due: May 31, 2011 FDIC/Fed/NCUA/OCC/OTS/SEC: The agencies are proposing Dodd-Frank related rules that require reporting of incentive-based compensation by a financial institution, in order to prevent inappropriate risks that could lead to material losses.</td>
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<td><strong>Availability of Funds and Collection of Checks</strong></td>
<td>Comments due: June 3, 2011 Fed: The Fed proposed changes to Regulation CC (Availability of Funds and Collection of Checks) to encourage banks to clear and return checks electronically, and to add provisions governing electronic items cleared.</td>
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<td><strong>Intangibles—Goodwill and Other (Topic 350)</strong></td>
<td>Comments due: June 6, 2011 FASB: The FASB proposed an exposure draft to simplify requirements for testing goodwill for impairment. The changes would allow entities to first assess qualitative factors to determine if it's necessary to perform the two-step quantitative impairment test.</td>
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<td><strong>Credit Risk Retention</strong></td>
<td>Comments due: June 10, 2011 FDIC/FED/ FHA /HUD/OCC/SEC: The agencies proposed rules that would require sponsors of asset-backed securities to retain at least 5% of the credit risk of the assets underlying the securities, with limited exceptions, as provided by the Dodd-Frank Act.</td>
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<td><strong>Resolution Plans and Credit Exposure Reports</strong></td>
<td>Comments due: June 10, 2011 FDIC/FED: The agencies issued a notice of proposed rulemaking for certain organizations to report resolution plans and credit exposure reports. The rule covers nonbank entities supervised by the Fed, and bank holding companies with $50 billion assets or more.</td>
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<td><strong>Swap Margin and Capital Requirements</strong></td>
<td>Comments due: June 24, 2011 FDIC/Fed, FCA/FHFA/OCC: Five agencies proposed a rule as required by the Dodd-Frank Act to establish margin and capital requirements for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants.</td>
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<tr>
<td><strong>Regulation Z—Truth in Lending</strong></td>
<td>Comments due: July 22, 2011 Fed: The Fed proposed changes in Reg. Z, Truth in Lending, which expand the scope of requirements for lenders to determine a consumer's ability to repay a mortgage before making the loan. The changes are mandated by the Dodd-Frank Act.</td>
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Deposit strategy

risen somewhat in the past six months, a five-year brokered CD is available at current pricing between 2.25% and 2.30%, including the cost of fees for the broker, Lephardt said.

When utilizing brokered CDs, it’s important to take a structured approach. “We really need to be focused on doing our funding and liquidity management in a portfolio type of mentality, and going out and not trying to time the market,” he said. “Put on the funding when you need it, because that way, you’re not going to get caught trying to make interest rate calls.”

In addition, it’s essential to adequately address any regulators’ scrutiny regarding the use of brokered deposits. Bankers should explain that such deposits and laddered maturities help fund the balance sheet to create liquidity in a strategic and methodical way, he advised.

Noting the importance of “strategic” deposit pricing, Lephardt said that institutions should consider utilizing a deposit-pricing committee, separate from the ALCO, which meets monthly or weekly to help implement a focused overall deposit strategy. This would monitor what the pricing rates should be and ensure that policies and procedures are in place and followed.

For example, the committee can help maintain deposit-pricing discipline in situations where a new customer requests that bankers match a higher deposit rate from another institution. He stressed that it’s essential to control costs, ensuring that core deposits remain core and that other deposits are as inexpensive as possible.

Further, an effective deposit pricing committee can continually preach this message to ensure that all levels of staff understand the pricing philosophy and priorities.

Bottom lines

Lephardt stressed that one of the major challenges for institutions in today’s low interest-rate environment—even though deposit prices tend to be very low—is that it’s still difficult to eke out net interest margin for the bottom line. A major reason is that even though deposit rates are quite low, there is very little spread due to the intense competition for loans.

“The biggest challenge, without a doubt, on the asset side of the balance sheet right now is not the fact that loans aren’t out there—but the ‘good loans’ aren’t necessarily out there,” Lephardt said.

Regulatory burdens

are extremely concerned that, under proposed regulations, community banks may not actually receive the benefit of the (debit) interchange fee-limit exemption explicitly provided for in the law,” she said. The FDIC sent a comment letter to the Fed, detailing those concerns.

In addition, she said that the FDIC is reminding examiners to “work cooperatively with financial institutions and to be aware of the great challenges that face community banks.”

Jennifer Kelly, OCC senior deputy comptroller for mid-size and community bank supervision, said that any banker who has concerns about a particular exam finding should “raise those concerns” with examiners or the district management team that oversees the institution.

“Should a banker not want to pursue those chains of communication, our Ombudsman’s office provides a venue for bankers to discuss their concerns informally, or to formally request an appeal of examination findings,” Kelly said.

The OCC supervises more than 1,200 community banks under $1 billion assets. In addition, the OCC also will assume responsibility on July 21 for 664 federal savings associations, including 220 mutual institutions, she noted.

Kelly acknowledged that Dodd-Frank imposes new requirements and restrictions on retail businesses that are “bread and butter” for many community institutions.

Regardless of how well community banks adapt to Dodd-Frank Act reforms in the long-term, in the near- to medium-term these new requirements will raise costs and possibly reduce revenue for community institutions,” she said.

“In the context of community banks, a particular concern will be whether these combine to create a tipping point, causing banks to exit lines of business that provide important diversification of their business, and increase their concentration in other activities that raise their overall risk profile,” she said.

FMS members are advised to consider communicating their concerns about over-zealous field examiners, questionable exam findings, and the costly impact of major regulatory burdens to appropriate regulatory officials, such as ombudsmen, at their regulatory agency.

You may review more details on regulatory burdens and related issues in the “compliance issues” category of the News Archive on the FMS web site at www.fmsinc.org.
We will be offering several upcoming special seminars to help savings institutions that currently submit a TFR in their transition to the Bank Call Report.

Two August seminars, in Philadelphia (Aug. 16-17) and Atlanta (Aug. 22-23), and a September seminar in Chicago (Sept. 13-14), will provide all the guidance you need to transition smoothly to the new report. They will explain the significant differences, and similarities, between the two reports, providing you with all the hands-on tools you need to prepare and understand your new report.

Attending one of the seminars will allow you ample time to collect the new data that will be needed well before the March 31, 2012 deadline.

The seminars will be conducted by one of our top-rated instructors—Paul Sanchez, CPA, CBA, CFSA; President, Professional Service Associates, who has been conducting our highly rated TFR and Call Report seminars for many years. Register online at www.fmsinc.org—or printed promotional literature will arrive shortly.