

Financial Managers update

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Strategic choices

Strategic reassessment needed in today's difficult environment

Small institutions need to carefully reassess their strategies for surviving in today's difficult environment, to ensure they can navigate successfully through the pressurized challenges weighing on bottom lines, an industry strategist warns.

Community-based institutions now face an enormous list of challenges, including perilous economic conditions, rising regulatory burdens, and decreasing margins.

"It seems like there's an overwhelming belief among some

that if you're under \$1 billion in assets, you may find it difficult to survive because you're not getting the same economies of scale that largeness lends itself to," says Barry Pelagatti, financial service group assurance partner, ParenteBeard LLC, Philadelphia, Pa.

Tough decision

For some institutions with fewer than \$1 billion assets, boards and top management seem to feel that they are facing the need to make an unequivocal but tough decision—

either we throw in the towel and sell, or we come up with a more effective operational strategy for sustainability in coming years.

The critical starting point for an institution's future survival is to make clear to everyone, both internally and to the community, that it is choosing to "sustain its existence rather than being a seller," Pelagatti said. "It has to start with the board—the board has to give the management team a sense of clarity that that's their desire."

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Over-zealous examiners

Regulators acknowledge major complaints surfacing among bankers

Regulatory officials recently acknowledged that serious complaints continue to surface among community institutions about the costly impact of over-zealous field examiners, even though agency officials have been stressing the need for supervisory approaches that are balanced and consistent.

In recent testimony at a House subcommittee field hearing, regulators from the OCC and FDIC pointed out major complaints that continue to surface, and offered practical advice for institutions that want to ensure their complaints

about field examiners are adequately heard.

In addition to addressing complaints, the regulators also noted the serious nature of financial challenges faced by some smaller institutions as a clear reason for ongoing close exam scrutiny.

Mixed messages

Some lawmakers say that complaints from bankers and small business owners about lending rules and related exams recently have become so common that the problem has even acquired a name—"mixed

messages." They note that while officials in Washington urge banks to "lend more," field examiners apply restrictive standards that make lending more difficult.

As previously reported, such complaints about over-zealous examiners have been surfacing for some time among small institutions and industry trade groups, noting instances of some examiners exhibiting such "misplaced zeal." (See *FMU*, May 17, 2011 for details.)

"Bank examiners must recognize the risks of over-regulation, and

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Hedge strategies

Growing interest seen for hedges related to lending

Hedging strategists indicate that in recent months there has been a growing amount of interest among institutions that are seeking out the benefits of hedge strategies related to lending.

Interest rate strategies utilizing derivatives-based hedges can be a constructive alternative for managing assets and liabilities more effectively in today's difficult economy.

Chris Fienup, hedging strategist in the derivatives product group at FTN Financial, Memphis, Tenn., recently pointed out some of the main types of strategies being used by community-based institutions to better manage IRR, while also helping to generate loans more effectively in the highly competitive environment.

Smaller institutions often find themselves in very competitive situations with "the larger brethren on the block—the big names that everybody knows," Fienup explained. "So they need this approach to compete—the bigger banks have been using these strategies for a number of years."

For example, he pointed out that it's very important for institutions in the \$300-million to \$1-billion asset range to be able to offer products that are similar to those being offered by

the large banks in order to compete.

But he also emphasized that institutions of all sizes—anywhere from \$50 million to \$25 billion in assets—recently have been making use of such hedging strategies.

Various hedge strategies are even being used by de novo institutions, which generally have much smaller loan portfolios than other institutions but have significant amounts of risk associated with individual loan deals, he said.

"To be able to hedge the IRR associated with a significant portion of their balance sheet is not necessarily dependent upon size," he said. "It's going to be more dependent upon the sophistication of the management and the lending teams."

Implementing a commercial hedging program enables an institution to offer the full flexibilities that are available with the swaps market, he said. "It's something that is very much needed."

Fienup said there has been growing activity in the following hedge strategies.

Cancellable swaps. This strategy allows a borrower to exit a swap at no cost. It's very attractive for borrowers who want to lock in a low, long-term fixed rate, but who believe they may

pay off their loan prior to maturity.

With this strategy, a customer can get out of the swap at certain discrete points in time. For example, if a borrower wants a seven-year loan at a fixed rate, the institution would provide a simple swap that offers a fixed rate in exchange for a floating rate hedging the loan. Under the swap contract, the borrower can exit the swap at no cost at a pre-set cancellation date in three years, or annually thereafter.

Forward-starting swap. This allows borrowers to lock in a fixed rate at a pre-set future date, providing the security that their financing will be fixed in the future. The beauty of the forward-starting swap is that a customer gets to take advantage of low floating rates where they are today, as well as a low fixed rate at a pre-set time in the future, Fienup said. "Many banks use this tool to lock up a good client in the future before the competition gets to them."

Such a product may appeal to customers who are afraid that interest rates will rise, but who also want to take advantage of today's extremely low rates, he added.

Draw-up period. Typically this strategy might be utilized

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Market value of equity

FMS white paper says important IRR tool under-utilized

A recent FMS white paper points out that market value of equity, while an extremely important tool for bankers, is often misunderstood and under-utilized by community-based institutions.

The paper, "The Importance of Market Value of Equity," explains that MVE, also known as net portfolio value or economic value of equity, is essentially a tool that allows institutions to gauge the long-term interest rate risk that they are taking and to determine

if the institution's returns are commensurate.

Authored by Dallas Wells, vice-president at Asset Management Group, Inc., the report explains that MVE should be used not only for measuring risks that already exist on the balance sheet, but also as a tool for determining ongoing strategy by testing the implications of specific campaigns or initiatives. It's available in the Member Resources section of the FMS Web site at www.fmsinc.org. 

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Rebuilding trust

Practical strategies to consider

Institutions can benefit by considering some of the operational strategies discussed in a recent banking survey that stresses the importance of rebuilding trust with customers.

In its 2011 Global Banking Survey, Ernst & Young highlights the challenges and operational implications of refocusing on the consumer following the recent financial crisis, especially when considered in combination with some of the regulatory changes that are occurring today.

“Customer confidence in the banking industry continues to be impacted by the credit crisis with 44% of customers saying their confidence has decreased in the past year,” the survey found.

Although the survey is mainly geared towards large institutions, small shops nonetheless may be able to glean some practical strategies to implement. Here are seven strategic ideas that it recommends for consideration.

First, bankers should develop a more in-depth understanding of the institution’s cost structure. Making correct decisions about product features, distribution channels, service levels and pricing is almost impossible without accurate cost models, it says.

Secondly, it’s important to identify

ways to leverage the institution’s existing infrastructure and assets, including information, in order to generate incremental revenue streams without incurring major capital charges. As one approach, the survey suggests institutions could package information and analysis about customer and segment financial behaviors in order to resell this to retailers, insurers and health-care firms.

Third, institutions should increasingly try to serve under-banked customers or otherwise underserved segments of the population. Since the competition for affluent segments is increasingly tough, it makes sense to develop creative and profitable ways to serve these less affluent customers through product design and other means.

Fourth, reevaluate operational and organizational models. While institutions have talked about being customer-centric, their operating models and organizational structures are still “silo-oriented” to a great degree. Thus, bankers may want to consider more customer-oriented structures for the organization.

Fifth, utilize measurement frameworks and metrics that are better

aligned with the institution’s strategy. For example, the survey points out that employing measures such as the efficiency ratio, net income, and return on assets to show the retail line of business performance does not always sufficiently account for risk. And, at a more granular level, the traditional measures used to determine branch profitability may also be flawed.

Sixth, institutions should consider broadening their distribution relationships with social media platforms. Retail and consumer-products firms recently have been quite creative in finding ways to leverage these channels.

Seventh, identify and close any gaps in the institution’s channels, operations, and information. Most banks have gaps in their distribution, servicing, and support infrastructures that will detract from success. For example, having separate call centers that do not “talk to each other” makes it hard to enhance customer service.

You may review further details on the survey in the management category of the News Archive on the FMS web site at www.fmsinc.org. **FMS**

Hedge strategies

from page 2

with construction loans, where a construction period will be fully funded at some point in the future and then begin its normal amortization. For example, a customer might obtain a fixed rate for the whole term involving a \$2 million loan that draws up for 18 months, and then begins to amortize over a seven-year period.

Swaps with floors. Floors that are used with swaps can enable institutions to obtain additional yield in the current environment.

Interest rate caps. Many borrowers that do not want a fixed-rate loan will take a floating-rate loan and purchase a cap as

an insurance premium. Thus, interest rate caps are purchased at a premium up front, and provide protection in the event that the underlying floating rate index exceeds a pre-set strike. So if borrowers are worried about long-term interest rates and want protection against a “runaway inflation event,” there are various cap options that can be purchased.

“These are a lot like fire insurance,” Fienup said. “You purchase it up front, and the protection is there in the event that you need it.”

Interest rate collars. “This keeps the borrower’s floating rate within a

specified range of interest rates and normally can be accomplished at zero cost to the borrower,” he said.

Blend and extend. Bankers are increasingly fighting over the loan customers they really want, but who already may have obtained older loans. However, many of those customers may have debt that’s already hedged with an interest rate swap. So this strategy involves restructuring a current swap for the borrower who has some time left before maturity and is above current fixed rates.

You may review further perspective and insights by searching for “hedging” in the Industry News Archive on the FMS web site at www.fmsinc.org. **FMS**

“Because if you have a board that is not sure whether they want to be a seller or a survivor, it’s very hard for management to implement an appropriate strategy,” he added. “So it starts with getting clarity from the board for management to have the confidence to develop a strategic plan that is not placed on goals set merely to increase your multiples.”

And for those considering increased multiples, he pointed out that for probably the next three to five years, a surviving bank is not going to be turning the world on its ear. “ROA is probably still going to be lower—all your metrics are going to be lower than you may want in an ideal environment,” he said.

“So the first thing you need is a vote of confidence from the board to say: yes, we do want to have a maintenance-and-sustainability strategy,” he explained.

Stumbling block

However, getting such votes of confidence from boards at smaller institutions today can be a challenge. Pelagatti explained that typically board members at most small institutions today reflect an aging demographic, with 62 years being the average age.

“I would probably refer to most of them as the pillars of the community—the known, mature people who have helped grow that community,” he said. “They are all very well respected—they have all demonstrated the ability to be successful in their communities.”

“But unfortunately,” he added, “although many of them are life-long financial people, they may find it difficult to keep up with the quickly changing landscape of today’s banking environment.”

Understandably, some are beginning to get tired. “If you’re a private organization, you’re looking for some sort of economic event to help compensate you for all this tenure that you’ve put in,” he said. “If you’ve been doing this for the average of 10 years, you’re probably saying: look, we don’t want to sit around for

the next three years and grow out of this; if we can sell, let’s sell.”

But if an institution is going to choose to survive, it must change the status quo. For example, Pelagatti noted that some institutions today face significant difficulties, since they have detached board members who are “just going through the motions,” often with a management team that is ineffective.

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Not surprisingly, he pointed out that when the composition of boards is a stumbling block to future survival, banking regulators have sometimes gotten involved, and have “really come down pretty heavily on those boards.”

In some cases, institutions have made clear on their own that as current board members reach the required retirement age, they are not being replaced. “Or if they’re replacing them, it’s with a demographic that’s much younger, more progressive, and less tied to the history of the organization,” Pelagatti said.

Nonetheless, if an institution wants to re-energize its strategic plan in order to achieve more

sustainability, other key executives probably need to get involved in the process. “We’re seeing that the onus is increasingly falling on the CFO, because the CEO is many times considered to be a board member,” he pointed out.

Unfortunately, many bank and credit union management teams tend to be very reactive. They typically are waiting for regulators to come in and tell them what to do, or for the government to say “here is a bailout, or here is the small business lending fund,” Pelagatti said.

However, if a board gives management an appropriate vote of confidence, and if management becomes more proactive, there’s no reason to believe the institution cannot develop a practical, forward-looking sustainability plan. “You can start to actually grow yourself into what you would like to be, rather than just waiting for someone to come knocking to see if you’re willing to be acquired,” he said.

With a strategic plan for sustainability, the institution can then create expectations for management, employees, and customers.

Especially important, he advises, management must address the issue of staff motivation. “Unfortunately, I think most employees are treating jobs at banks now purely as jobs—not as career growth opportunities,” Pelagatti said. “So we don’t see a lot of succession planning in banks.”

One of the greatest concerns he sees right now is that most bank employees do not have what they perceive to be job security. “They feel as if they’re just waiting to hear who’s firing them,” he said. “And therefore, they’re also just saying: we’re coming to work every day to have a job, but it’s hard to have a career path to want to add value to the organization.”

However, once management has an effective plan, it can instill in employees the “confidence you have a plan and they are part of it,” he explained. “If you’re a community bank, your employees are part of the community and you have to instill

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particularly avoid subjecting smaller financial institutions to undue regulatory burdens,” warned Rep. Spencer Bachus (R-Ala.), chairman of the House Financial Services Committee. “We cannot allow regulatory micromanagement of community banks to stifle prudent lending.”

Not surprisingly, as the volume of complaints has risen, House lawmakers in July passed a bill aimed at addressing the “mixed-messages” problem. Sponsored by Rep. Lynn Westmoreland (R-Ga.), the bill (H.R. 2056) would, among other things, require the FDIC’s inspector general to review the impact of such practices and procedures on community banks, and report back to Congress.

At the recent subcommittee field hearing, Gil Barker, OCC deputy comptroller for the southern district, acknowledged some bankers believe they are getting “mixed messages” about the need to make loans to creditworthy customers—but at the same time being subject to over-zealous exams.

“In particular, some bankers have stated that their ability to meet the needs of their communities is being constrained by what they regard as overly aggressive regulatory loan classifications and the substitution of examiner judgment for that of bank management,” Barker said.

Recent complaints about field examiners charge that they are:

- Barring loans to certain borrowers or industries with problems, or criticizing loans simply because they are located in a state with a high mortgage foreclosure rate.
- Telling institutions they can no longer work with a borrower because the examiner has classified the borrower’s loan.
- Classifying loans to borrowers who are current and can meet their debt obligation—situations sometimes referred to as “performing non-performing” loans.
- Criticizing loans or borrowers simply because the current market value of their collateral has declined, and forcing banks

to write down loans to current distressed market values.

- Over-reaching and second-guessing bankers and professional independent appraisers.
- Penalizing loan modifications by aggressively placing loans on nonaccrual status following a modification, even though the borrower has demonstrated a pattern of making contractual principal and interest payments under the loan’s modified terms.
- Applying de facto higher regulatory capital requirements in an arbitrary manner, thus constraining the ability of banks to lend.

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Southern District
OCC*

Despite the complaints, Barker emphasized that his agency’s message to examiners is: take a balanced approach; communicate concerns and expectations clearly and consistently; and encourage institutions to work with troubled borrowers in a prudent manner and extend new credit to creditworthy borrowers. During exams, he added, “our goal is to review and confirm bank management’s assessments, not to ‘second-guess’ or supplant their judgments with ours.”

Barker, whose OCC district supervises more than 650 federally

chartered community banks and thrifts, nevertheless defended the actions of his agency and its examiners. “We have quality assurance processes to ensure our examiners are applying our guidance consistently,” he said. “Every report of examination is reviewed and signed off by an appropriate OCC manager before it is finalized.”

While such regulatory policies and procedures establish a consistent framework and expectations, the examiners always attempt to tailor their supervision of each bank to its individual risk profile and business model, he explained. “Our front line managers, who are located in local communities, are given considerable decision-making authority, reflecting their ‘on the ground’ knowledge of the institutions they supervise.”

Impaired loans

For example, if a borrower’s ability to repay a loan becomes impaired, the institution is expected to classify the loan to recognize the increased risk, he stressed. “A loan is not classified simply because a borrower is based in a certain geographic region, operates in a certain industry, or because the current market value of the underlying collateral has declined.”

“While I believe that OCC examiners are striking the right balance in their decisions, my management team and I encourage any banker that has concerns about a particular examination finding to raise those concerns with his or her examination team, supervisory office, or with me or the OCC’s independent Ombudsman,” he said.

During the hearing, the FDIC also underscored the economic pressures weighing on smaller banks today. It noted that as of March 31, there were 888 institutions nationwide on the FDIC’s problem bank list, representing about 12% of all FDIC-insured institutions. “This is the highest volume of problem institutions in nearly 20 years,” it said.

The FDIC stressed that it wants to ensure fair and consistent bank examinations, which is vital for the nation’s economic recovery. While

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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.

Credit Union Service Organizations

Comments Due: Sept. 26, 2011

NCUA: The NCUA proposed changes in credit union service organization rules to address certain safety and soundness concerns, including investment limits for credit unions that are less than adequately capitalized.

Shelf Eligibility Requirements for Asset-backed Securities

Comments Due: Oct. 4, 2011

SEC: The SEC voted to re-propose some rules requiring greater accountability and enhanced quality around asset-based securities when issuers seek to use an expedited registration process known as shelf registration.

Corporate Credit Unions

Comments Due: Oct. 6, 2011

NCUA: The NCUA proposed amendments to its rule governing corporate credit unions in order to clarify certain provisions and make technical corrections.

Retail Foreign Exchange Transactions

Comments Due: Oct. 11, 2011

Fed: The Fed proposed rules to permit institutions under its supervision to engage in off-exchange transactions in foreign currency with retail customers.

Supervised Securities Holding Companies Registration

Comments Due: Oct. 11, 2011

Fed: The Fed proposed a rule outlining the procedures for securities holding companies (SHCs) to elect to be supervised by the Fed. An SHC is a non-bank company that owns at least one registered broker or dealer.

Information Collection for S&L Holding Companies

Comments Due: Nov. 1, 2011

Fed: The Fed proposed a two-year phase-in period for most S&L holding companies to file regulatory reports with the Fed, and an exemption for some S&L holding companies from initially filing such reports.

Mandatory Auditor Firm Rotation

Comments Due: Dec. 14, 2011

PCAOB: The PCAOB issued a concept release to solicit comments on proposed ways that auditor independence and objectivity could be enhanced. One approach is mandatory auditor firm rotation.

Nationally Recognized Statistical Rating Organizations

Comments closed: Aug. 8, 2011

SEC: The SEC proposed new rules to increase transparency and improve the integrity of credit ratings. The proposal, mandated by Dodd-Frank, would enhance existing regulations addressing credit ratings and nationally recognized statistical rating organizations.

Capital Plans

Comments closed: Aug. 5, 2011

Fed: The Fed proposed rules that would require top-tier U.S. bank holding companies with total consolidated assets of \$50 billion or more to submit annual capital plans for review. The aim of the review is to ensure institutions have robust, forward-looking capital planning processes.

Credit Risk Retention

Comments closed: Aug. 1, 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.

confidence in them to help you make it happen.”

By defining expectations for employees within this context, management should also be better able to empower staffers to further connect with potential customers in the community. For the last 15 years, institutions have been saying: we’re customer focused—but customer satisfaction in the last 15 years seems to have decreased, Pelagatti said.

Knowing customers

So, as part of the sustainability plan, institutions need to reassess whether they really know their customers today. As an example, he pointed out that many customers in the baby-boom generation will soon retire. Eventually, they will pass along their wealth to the younger generations, but what is going to allow the institution to maintain that wealth within the bank?

He cited two examples of customer-focused strategies now being used to meet the needs of boomers in terms of such life-phase transitions. One institution

has begun to do branching in retirement homes; and it’s also going out and meeting with those people and their primary care-

The bottom line is that to survive in the future, small institutions must come to terms with not only the difficult economy, but also the changing ways in which banking customers do their banking and what’s required to facilitate that.

*Barry Pelagatti, Financial Service Group Assurance Partner
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givers to help them establish a plan for what they need to do during their transition period.

Also, another institution has

formed relationships with funeral directors who will help retiring boomers that come in and need assistance with estate management.

Once established and clearly articulated, any sustainability plan’s implementation must include encouraging all staffers—not just those in the upper echelon—to get further involved in representing the institution within the community.

“Many may not have been doing anything,” Pelagatti said. But if they know that part of the expectations related to their compensation is to get involved in things like charitable foundations, or summer events like competitive 5-K running, this connection with possible customers can pay off. “Everyone likes to call themselves a community bank, but how many are actually participating in community events?” he said.

The bottom line is that to survive in the future, small institutions must come to terms with not only the difficult economy, but also the changing ways in which banking customers do their banking and what’s required to facilitate that. “I think it’s the business of banking itself that’s changing,” Pelagatti said. **FMU**

Over-zealous examiners

community banks represent only 11% of industry assets, they provide 38% of the industry’s small business loans to businesses and farms, it said.

Agency outreach

“We are aware of concerns expressed by some bankers that examinations are being conducted in an overly conservative manner during this challenging economic time,” the FDIC said. “To address these perceptions, we have expanded our outreach at the national, regional and state level to broaden our communication with both individual banks and trade associations.”

The FDIC stressed that it welcomes feedback from the industry and relies on bankers’ informed perspective as it refines its supervisory process. Examiners are expected to adhere to the agency’s exam policies,

procedural directives, guidance issued to the industry, and prudential bank supervision tenets. The agency takes great care to ensure national consistency in examinations, it said.

However, the FDIC also noted that “questions about and even disagreements with our findings may sometimes arise, especially in difficult economic times.”

Thus, the FDIC provides both formal and informal outlets for institutions to register their concerns. “We have found that the most effective method for understanding FDIC supervisory conclusions is to raise concerns with the examiner-in-charge or the appropriate field or regional office,” it advised.

Bankers can informally contact FDIC offices by phone or email, or request a meeting in person. If an institution is unable to resolve

its concerns—or believes that the regional office is not carrying out FDIC policies—the institution is encouraged to contact the FDIC’s Washington office.

And if these informal channels do not resolve concerns, a formal appeals process is available by contacting the FDIC ombudsman. “The FDIC strictly prohibits any retaliation or retribution by any examiner or employee against any institution,” it said.

“FDIC bank examiners have strong professional skills and judgment, and understand the significant efforts that banks are making to address the complexities of this environment,” it said. “They are working diligently to implement our balanced approach to bank supervision.”

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. **FMU**

FMS Education Calendar

Webinars

Sept. 27 and
Oct. 4 Core Deposit Analytics

Seminars

Atlanta, GA

Sept. 20-21 Implementing SOX 404/FDICIA
Sept. 22-23 Enterprise Risk Management

Madison, WI

Oct. 9-14 Financial Managers School

Indianapolis, IN

Oct. 25-26 Measuring and Managing IRR
Oct. 27-28 Investment Portfolio Management
Nov. 9-10 Best ALM Practices for Credit Unions

Nashville, TN

Nov. 15-16 Risked Based Audit
Nov. 17-18 Accounting Basics
Nov. 17-18 Best Practices in Loan Review

(Calendar is subject to revision when program changes occur.)

For details, visit www.fmsinc.org/calendar
or call (800) ASK-4FMS (800-275-4367)

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