Financial Alert

Management & Compliance Solutions for Financial Institutions

September 2002

Modeling is more than *fashionable*

by Paula Eissfeldt, Decatur

Many management tools arrive with abundant hype and flash, but some prove impractical over time. That's why financial institutions view new tools with healthy skepticism and are often slow to embrace them.

You've probably heard a lot about modeling and wondered if it's just the latest fad on the convention circuit. It attracts attention with good reason. After all, it's one of the most prudent techniques you can use.

Modeling is built on reality, specifically, your financial institution's reality. Managers and directors use modeling to examine possible long-term effects of different strategies so they can make informed choices on matters that affect future viability.

Modeling also helps determine whether your strategic goals and objectives are congruent with your situation. Knowing how today's decisions affect tomorrow's return on equity (ROE) or shareholder value will position your institution for success.

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Capital modeling

Capital is the lifeblood of a financial institution. When formulating or updating a strategic plan, it is critical to determine future capital levels.

When various strategies are considered, a well-constructed model offers a valuable "what-if" analysis tool to measure the potential effects each option or enhancement will have on capital.

Quite simply, here's how modeling works: assume you will maintain the current level of operating performance. Next, introduce a variety of potential capital enhancements to the model to determine the effect they'll have on capital.

The model will help you compare capital projections resulting from each enhancement to those that can be expected without enhancements. In this way, you can determine beneficial strategies for the long term.

Modeling can help you study the impacts of:

- ▲ Stock issuance or redemption programs
- ▲ Acquisitions
- ▲ De novo branch formation
- ▲ Profit enhancements
- ▲ Dividend increases and decreases

Capital modeling is an effective tool because it involves the creation of 10-year projections driven by the desired return on average equity.

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STAR wants SCRs by September 30

by Barry Floerke, St. Louis

Beginning this year, all members of STAR, including nonprocessing members, are required to submit a security compliance review (SCR) by September 30.

The purpose of this biennial review is to confirm all ATM devices and the DES keys inside them are compliant with PIN security standard guidelines.

In the past, only direct and indirect processors were required to submit an SCR to STAR. Now, both must complete the TG-3 audit.

Nonprocessing members must complete a more simplified version of the TG-3 that audits the functions they perform themselves as well as those outsourced to a third-party vendor (ESO/ Vendor).

The SCR is divided into five questionnaires that relate to those functions.

If the processor performs any key management functions for the nonprocessing member, nothing needs to be submitted for that specific function.

However, if the nonprocessing member outsources any key

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BKD LLP

Modeling more than...

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Mergers & acquisitions

While mergers and acquisitions are common in today's financial services landscape, the results don't always parallel expectations. Applying various pricing options to the model before finalizing a transaction provides a better sense of how a merger or acquisition will affect shareholder value.

Modeling offers insight into the impact on regulatory capital. This technique also can be used to study the structure of a transaction.

Branch acquisitions

Your competitor's branch looks like a good buy. The location fits in with your long-term plans: the brick and mortar is sound, and the price is right. Here again, modeling techniques can help you determine the true financial impact of the acquisition.

The analysis you perform and the projections it provides help you monitor the effect on regulatory capital ratios, and you'll be better able to assess the amortization of any premium you'll pay.

De novo planning

Whether you're thinking of starting a financial institution from scratch, or considering a from-the-ground-up branch, modeling can reduce the complexity of decision making.

A start-up analysis based on your desired returns helps you determine the amount of capital you'll need to satisfy regulatory requirements and the size and composition of your staff. The insight and information you obtain also may benefit the often cumbersome application process.

Choosing charters

If you're considering a change in charter or if recent mergers and acquisitions have left a crazy quilt of charters, modeling can help you make the right choices.

A charter modeling analysis concentrates on the economic impacts that come with changing charters but also offers important insight into the regulatory and social aspects. A thorough analysis brings a variety of issues to light, helping you make a more informed and more intelligent decision.

...strategic modeling...does much more than make numbers look attractive

Rewarding performance

A little known use for modeling is developing simplified incentive compensation plans for officers and employees. Plans of this type are based on local and regional peers and high performers and are driven by ROE. When properly implemented, they enhance shareholder value and bolster employee satisfaction and retention.

More than looks

As you review the opportunities offered by strategic modeling, you will realize it does much more than make numbers look attractive. It's a proven, prudent approach to improving decision making and helps your institution achieve continued viability and success.

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If you would like to discuss how financial modeling could benefit your financial institution, contact your BKD Financial Institutions Group advisor.❑

Accountability

BKD, you & the new rules

The *Public Company Accounting and Investor Protection Act of 2002* signed into law July 30 by President Bush contains several provisions affecting **public companies.**

The Act's provisions do not affect private companies, not-for-profit organizations and governmental entities.

BKD is monitoring interpretations of the new rules as a new oversight board is formed and the Securities and Exchange Commission (SEC) develops regulations. If you are a public company client, you will likely have already discussed with your BKD engagement partner how the Act will affect your organization and affect our responsibilities to you.

If you have questions about our quality control standards, contact your BKD advisor.

Key provisions

Creates oversight board - The Act provides for the creation of a Public Company Accounting Oversight Board, accountable to the Securities and Exchange Commission (SEC), to oversee audits of public companies and related matters.

Limits nonaudit services - The Act also prohibits an auditor from performing certain nonaudit services for its public clients, such as bookkeeping, financial systems design, appraisal/valuation, actuarial, internal audit, management, investment-related and legal services.

Final regulations for these prohibited services will be developed by the new Public Company Accounting Oversight Board or the SEC and are due within six months. The prohibition on these services is effective 180 days from the date the new board is formed. We will keep you informed as regulations are developed for such services.

Strengthens audit committees - The Act further defines the role of the audit committee and its oversight responsibilities with the auditor.

Provides for many other changes - The Act includes changes related to retention periods of audit workpapers, new reports, rotation of lead audit partners and reviewers, criminal penalties for record destruction or falsification and other issues.❑

> For nearly 100 years, BKD has been known for its integrity and honesty in client relations. Our founders set the standard: know right from wrong, then do what's right. Clients trust us to advise them on how to "do what's right" and to conduct their business affairs responsibly.
>
> We remain committed to this high standard and to continuing to provide practical, timely and affordable solutions to your business and financial needs, within our code of ethics and the law.

It's not just disaster recovery anymore

by Gary Farrar, BKD Technologies

For years, financial institutions have been required to have a plan for restoring computer systems should a disaster occur. However, these plans apply only to computer systems and do not address restoring the everyday functions of an institution.

Restoring computers accomplishes nothing if people lack other critical tools necessary for doing their jobs. For example, a new account representative needs not only computer systems to perform his/her job but also new account forms, a suitable workspace, disclosure statements, etc.

The term "business continuity planning" (BCP) is now the operative term for disaster planning. It takes a more holistic view of the organization, providing for the recovery of entire business processes or functions rather than computer systems only.

How do you make the transition from disaster recovery planning to BCP? Here are some tips:

Focus on business processes instead of computer systems. Remember, your goal is to be able to restore important business functions not just computer systems.

Inventory and prioritize business processes. A common mistake is to define processes as the things that occur within a single department when, in fact, business processes usually cross multiple departmental boundaries. If properly defined, a financial institution will have an average of eight to 12 core processes.

Analyze the processes to determine the resources needed to recover them. Do not overlook the importance of people in the process; without people who have specialized skills and abilities, most business processes could not be performed. Ask, "If we started with nothing, what would we need to perform this process?".

Identify and document suppliers for your resources. If it is critical to restore some processes more quickly than others, you may decide to pre-position resources or hold them in reserve. In some cases, arrangements may be made with vendors to supply certain resources on short notice. In other cases, it may be acceptable to acquire them through normal purchasing channels after a disaster occurs.

Write specific instructions for recovering each process. Never assume key people will be available to assist with recovery. Instructions must be clear and complete enough for someone with limited knowledge of the process to follow.

Define roles and responsibilities, and train people to perform them. Allow the recovery team to practice by testing the plan. This trains the team and validates the plan's workability.

Follow these tips and you will be on your way to having a comprehensive business continuity plan. For more information, contact your BKD Financial Institutions Group advisor or a BKD Technologies advisor.❏

Recent regulations to mandate customer identification program

by Sean Kulczycki, St. Louis

On July 17, 2002, the Treasury Department issued proposed rules that would require financial institutions to establish procedures for verifying the identity of customers seeking to open new accounts.

The proposal would require financial institutions to implement a written customer identification program (CIP), approved by the institution's board of directors and included in any existing antimoney laundering program.

Before opening or adding a signor to an account, a financial institution must have an individual's name, date of birth and address of residence (or mailing address if different). The address of principal place of business may be substituted for nonindividuals.

The CIP must contain "risk-based procedures" for verifying the information obtained. U.S. citizens must provide a taxpayer identification number. Noncitizens must provide one of the following documents:

- ▲ U.S. taxpayer identification number
- ▲ Passport number and country of issuance
- ▲ Alien identification card number
- ▲ Current government-issued document with number and country of issuance (must state the individual's nationality or residence and display their photograph)

For corporations, partnerships, trusts and persons other than individuals, a financial institution must obtain documents proving the organization's existence, such as registered articles of incorporation, a government-issued business license, partnership agreement or trust instrument.

A final regulatory twist to the CIP is that it include procedures to determine if a potential customer is on any federal agency's list of known or suspected terrorists or is a member of any terrorist organizations.

Your financial institution already may use some of these procedures, but be sure you are aware of record requirements. All information obtained from a customer must be kept five years after the account has closed. This includes a copy of any documents used to verify information.

These regulations will go into effect on October 25, 2002. We recommend you develop and implement the necessary procedures as soon as possible.

For assistance in developing your CIP, contact your BKD compliance representative.❏

STAR...

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management functions to an ESO/Vendor other than the processor, then an ESO/Vendor Reporting Form and the related questionnaires must be completed and submitted by the vendor.

A nonprocessing member must complete and submit the related questionnaire if they perform any key management function themselves.

Contact your BKD Financial Institutions advisor for more information about how we can help you complete this review.❏

Put decision costing to work for your financial institution

by Doug Hicks, Indianapolis

The fundamental purpose of a for-profit financial institution is to generate value for its owners; in other words, to make you money. Few would consider a day-to-day cost-accounting system part of that purpose.

However, the purpose of your financial institution's cost information should be consistent with the purpose of the institution itself—to make money!

Why then, when an organization needs cost information, does it either begin a costly and time-consuming implementation of a new cost system or do the opposite and live with inadequate cost data because a system implementation would be too costly and time consuming?

Know what you need

Accurate cost information can benefit your financial institution; however, accurate and relevant decision costing information should be the objective, not precise cost-accounting information.

You can have a complex, detailed cost system in place that generates precise cost information for accounting purposes, yet fails to provide adequate information for either day-to-day or stand-alone business decisions.

On the other hand, with the appropriate decision-costing tools you can improve profitability by making business decisions based on sound cost economics, even though your day-to-day costing system may be less than perfect.

Complex job worth effort

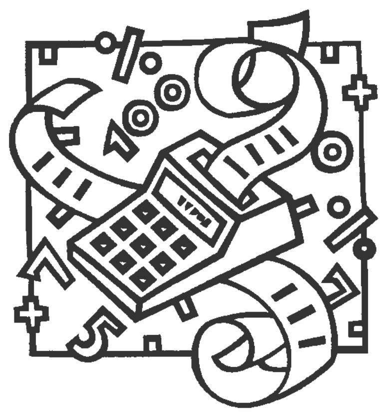
Changing an entire cost accounting system can be a monumental task, so should you go to the trouble?

Remember, the purpose of a for-profit organization is to make money. So how much knowledge is necessary about an institution's costs to help it make more money?

First, you need an understanding of how your costs affect product and customer profitability. Second, it's important to know what costs are involved in performing day-to-day activities so they can be reduced or possibly eliminated.

Total system overhaul? No!

Does your financial institution need to change its day-to-day accounting system to meet these decision-costing needs? Absolutely not. The required cost information can be generated by developing a decision-costing model, including these and any other critical activities with costs that have a significant impact on your company's operation.



A well-designed model includes the main elements of the company's operation and their interrelationships. This can be used to support all decision situations in which cost is a factor—whether those decisions require fully absorbed cost information or incremental cost information. Even the best cost accounting system cannot make that claim.

Know to grow

In today's competitive environment, accurate and relevant cost information that supports your business decisions is critical for your institution's growth. A complicated, hard-to-maintain, day-to-day cost accounting system is not.

A well-designed decision-costing model will provide the information necessary for your financial institution to succeed in its fundamental purpose—making more money!

BKD can help

Contact your BKD Financial Institutions Group advisor for information on how we can be a decision-costing solution for you.❑

How to Reach BKD

For a complete list of our offices and subsidiaries and their contact information, go to bkd.com or call Director of Communications at 417 831-7283.

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