Financial Alert
Management & Compliance Solutions for Financial Services Organizations
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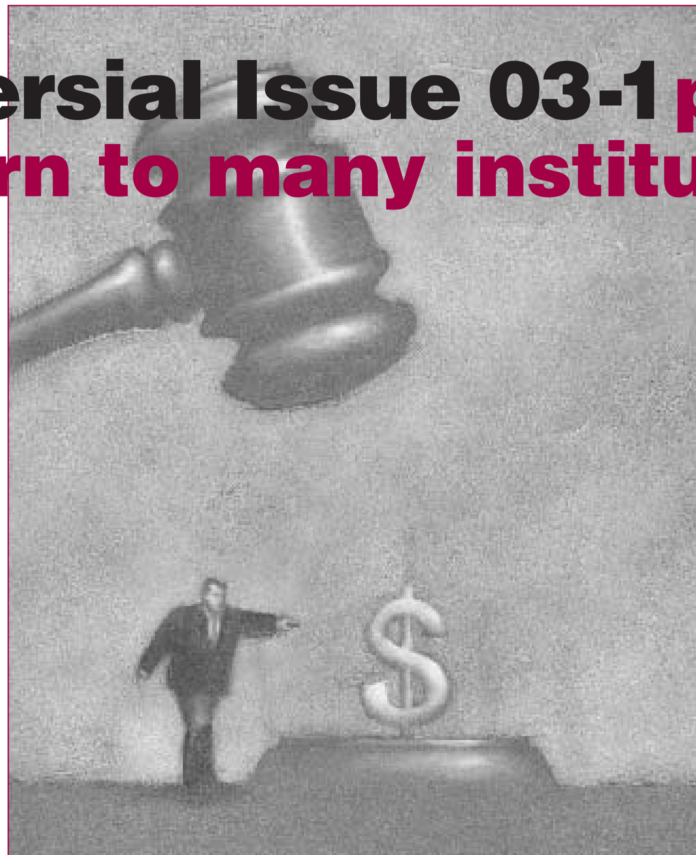
Controversial Issue 03-1 provisions of concern to many institutions



by Mike Wolfe, Springfield, mwolfe@bkd.com

Earlier this year, the Emerging Issues Task Force of the Financial Accounting Standards Board (FASB) reached final consensus on Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*.

The consensus provides guidance on determining when certain investments are "other-than-temporarily" impaired.

Certain provisions of Issue 03-1 have drawn criticism from many in the financial services sector. In response, a FASB Staff Position (FSP) was issued to provide additional guidance on Issue 03-1.

However, many institutions are concerned about the implications of this guidance and Issue 03-1 provisions that may affect asset/liability management practices.

Issue 03-1 presents three-step process

Several current accounting rules, including FASB Statement 115 (FAS 115), contain a requirement to treat "other-than-temporary" unrealized losses in the same manner as realized losses.

The term "other-than-temporary" was not previously defined in the accounting literature.

Issue 03-1 prescribes a three-step process for determining when a security is other-than-temporarily impaired:

Step 1 - An investment security is impaired if its fair value is less than its cost basis. In other words, debt and equity securities in a cumulative unrealized loss position are considered impaired.

Step 2 - For all equity securities and for debt securities that can be contractually prepaid in such a way that the investor would not recover all of its cost, *e.g.*, mortgage-backed securities, impairments are other than temporary unless:

- ▲ The investor has the **ability** and **intent** to hold the investment for a reasonable time period sufficient for a **forecasted recovery** of fair value, and
- ▲ The weight of the evidence indicates the cost of the investment is recoverable within a reasonable period of time

For all other debt securities, impairment is considered other than temporary if:

- ▲ It is probable the entity will not collect all amounts contractually due, *e.g.*, credit losses, or
- ▲ The entity does not have the ability and intent to hold the investment to a forecasted recovery

Forecasted recoveries must be **evidence based**, which may be difficult for equity securities. Factors to consider include the severity and duration of the impairment.

Generally, the more severe the impairment and the longer the impairment duration, the more difficult it will be to overcome the

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Institutions face BSA compliance changes

by Susan Speake, St. Louis, sspeake@bkd.com

Just as we're finally getting comfortable with the customer identification program requirements of the *USA PATRIOT Act of 2001*, we now must wrestle with renewed scrutiny of programs initiated under the *Bank Secrecy Act of 1970* (BSA).

The primary concern of regulatory agencies is antimoney laundering (AML) methods and the need for financial institutions to adopt coordinated efforts for identifying, preventing and reporting suspicious activity.

This general trend in regulatory expectations has encouraged many institutions to identify "high-risk customers" and perform AML risk assessments.

High-risk customers are typically identified by the type of business they engage in. Issued by the Office of the Comptroller of the Currency (OCC), the **Comptroller's Handbook on Bank Secrecy Act/Anti-Money Laundering** lists 17 types of businesses it considers high risk.

To be placed on the list, a business's legitimate activities would have to effectively disguise and/or facilitate the laundering of illegal proceeds.

For example, cash-intensive businesses, such as convenience stores, are identified as high risk because illegal cash proceeds can be combined with legitimate cash receipts without arousing suspicion.

On the other hand, automobile, watercraft and aircraft dealerships are identified as high risk because their products can be purchased with cash and can then be resold and purchased with a cashier's check or other negotiable instrument.

A complete list of high-risk businesses is available at OCC's website: **http://www.occ.treas.gov/handbook/bsa.pdf.**

In addition to helping identify any external risks your customers pose, AML risk assessments can help pinpoint those posed by specific products, services and delivery systems you use.

Being aware of your unique AML risks will help you control risk and strengthen your institution's BSA program. As compliance becomes more complicated, we recommend a proactive approach to regulatory changes.

* * *

The compliance process may be difficult because regulatory agencies do not provide much guidance about their expectations, but it also may mean they may be more open to the approach you choose.

Contact your BKD Financial Services Group advisor for more information about AML risk assessment and other helpful BSA compliance tools.❑

BKD Financial Institutions Group is now

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TOLIs & fiduciary risks require careful tr

by Ryan Underwood, Little Rock, runderwood@bkd.com & Jason Prather, Legacy Capital Group, Little Rock

An irrevocable life insurance trust (ILIT) is one of the most basic and fundamental estate-planning vehicles in use today. In fact, trust-owned life insurance (TOLI) is often a crucial element in a client's overall estate plan.

Despite this asset's importance, many trustees, corporate and individual, fail to properly monitor, manage and assess TOLI performance.

Such lapses can result in litigation because when a TOLI fails, it can cause a client's entire estate plan to unravel.

Substantial damages can be sought against trustees who fail to monitor and address whether a trust's life insurance policies are the best products available in the current insurance market.

Trustees must review & evaluate

Many life insurance policies

Trustees must consider whether an existing policy is competitive in today's market

available today are extremely complex contracts. Unlike in the past, today's consumers have access to a large volume of different types of

Jobs Act: financial institutions will feel its effect

by Gary Genenbacher, Decatur, ggenenbacher@bkd.com

Signed into law October 22, the *American Jobs Creation Act of 2004* (Jobs Act) has many applications to the financial services industry.

Among its provisions are continued enhancements for S corporations, as well as those affecting business deductions.

S subchapters enhanced

When financial institutions were first allowed to be S corporations in 1997, the shareholder threshold was 75, a total the Jobs Act increased to 100.

More importantly, the rules also changed for who is considered one shareholder. To make S corporation status more readily available to financial institutions, the Jobs Act contains provisions that apply specifically to them.

A husband and wife will continue to be considered one shareholder, but, effective for tax years beginning after December 31, 2004, a family may elect to treat as one shareholder *all* family members.

Family members include **common ancestors and their lineal descendants and the spouses (or former spouses) of the lineal descendants or common ancestor.**

An individual is not considered a common ancestor if more than six generations removed from the youngest generation of shareholders who would be family members.

As a result of this provision, many family-owned financial institutions may now qualify for S corporation status.

IRA breakthroughs

Individual retirement accounts (IRAs) also received a breakthrough from the Jobs Act, which says an IRA or Roth IRA may hold shares of an S corporation that also is a financial institution.

At press time, this did not include shares of S corporations that also were financial institution holding companies.

Shares must be held in the IRA or Roth on October 22, 2004, and the individual beneficiary of either is treated as the shareholder.

Certain transactions between an IRA and its beneficiary were prohibited before the Jobs Act, which has a specific exemption that allows a beneficiary to acquire shares from an IRA if specific criteria are met.

Business-expense deductions

The Jobs Act extends through 2007 both the increased $100,000 taxpayers can deduct under Section 179 and the increased $400,000 phase-out threshold, and both amounts are indexed for inflation.

Deductions continue for off-the-shelf software and SUVs acquired after October 22, 2004, and the Section 179 limit for any year is $25,000.

Qualified leasehold improvement property placed into service between October 23, 2004, and December 31, 2005, is considered 15-year modified accelerated cost recovery system (MACRS) property. Traditionally, these costs were depreciated over 39 years. The new rule allows certain costs to be depreciated on a straight-line basis over 15 years, and the definition of qualified leasehold improvement property is rather specific.

ISOs under Jobs Act

Incentive stock options (ISOs) enhance corporate value and executive compensation; however, the Jobs Act places into law an important IRS announcement.

The law overturns the proposed regulations that exempt from the *Federal Insurance Contributions Act* and the *Federal Unemployment Tax Act* wage income from the exercise of a statutory stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.

2004 Tax Law High-

In addition, the exercise of a statutory stock option—or the disposition of stock acquired pursuant to exercising a statutory stock option—are not subject to income tax withholding.

These provisions do not relieve a taxpayer from the potential alternative minimum tax (AMT) resulting from the exercise of ISOs or the regular tax resulting from a disqualifying disposition of an ISO. An ISO holder needs to take AMT into consideration sooner than later. Improper planning can result in a tremendous tax cost.

Contact your BKD tax advisor about these and other provisions.❑

ustee management

policies, with many designed to accomplish specific objectives.

Life insurance is no longer a "buy and hold" type of asset. Understanding how these modern, complex contracts work is a trustee's difficult and important task.

. . .it is the trustee's responsibility to recognize whether the current policy is underperforming, no longer competitive or if it is no longer appropriate

Through regular reviews, trustees also are charged with reviewing a policy to be sure it performs as it was designed to. Over time, the type of insurance product best suited for a particular person or purpose often changes.

This may be the result of a change in the insured's financial, family or marital status, a change in the insured's health or habits or simply because a new, more competitive product becomes available.

In any event, it is the trustee's responsibility to recognize whether the current policy is underperforming, no longer competitive or if it is no longer appropriate.

The above factors and the *Uniform Prudent Investor Act of 1994*, which provides standards for trust asset management and investment, have made an ILIT trustee's role far more complex than most people realize or understand.

However, this potentially volatile situation is drawing more attention because increasing numbers of trustees are being sued for mismanaging life insurance policies.

Surveys indicate common problems

A 2004 survey published in the wealth management journal **Trusts and Estates** noted 83.5% of professional trustees said they lacked guidelines or procedures for handling trust-owned life insurance.

Further, 95.3% of professional trustees had no guidelines for handling or monitoring the asset allocation components of variable life insurance contracts.

Another survey indicated between 70% and 95% of all trust-owned life insurance policy contracts are no longer served by an active life insurance agent. It is apparent little is being done to manage or monitor this important portion of a client's estate plan.

Consider policy restructuring

Trustees must consider whether an existing policy is competitive in today's market. New product development and decreased mortality costs have lowered the cost of many of today's policies, making them less expensive than those issued in the past.

If a trustee can prove the benefits of active asset management to a client, it can strengthen their relationship

A recent **National Underwriter** article says 92% of one professional trustee's existing trust-owned policies could be restructured to provide at least 20% greater value.

In addition, 74% to 87% could be restructured to provide either a 40% increase in death benefit or a 40% reduction in premium.

These numbers are significant and alarming. Considering the multiple millions of dollars in death benefit amounts in TOLIs held by corporate fiduciaries, trustees can be exposed to substantial liability. Very few trustees understand or recognize this liability.

If properly managed, substantial opportunities exist for corporate trustees to provide valuable and potentially large benefits to the grantor and beneficiaries of the trust.

Accomplish this by decreasing the policy's cost or increasing the death benefit's amount, potentially increasing the assets the trustee might eventually manage.

In addition, if a trustee can prove the benefits of active asset management to a client, it can strengthen their relationship and, in turn, increase the possibility that the client's death benefit proceeds will be retained as assets under the trustee's management.

What trustees can do now

Consider employing an individual from the trust department who understands life insurance products and can review existing TOLI products; this will help you determine if products are performing adequately or if a better one is available.

Another solution is for the trustee to consult an independent insurance agency that is current with today's life insurance products and also has purchasing power to acquire the most competitive products on the market.

Such agencies have developed the software and expertise to evaluate current TOLI products; some will perform an evaluation at no cost if they are allowed to propose any necessary modifications.❑

Check out. . .

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Controversial . . .

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other-than-temporary impairment presumption.

Step 3 - If the impairment is other than temporary, an impairment loss equal to the difference between the investment's cost and its fair value must be recorded at the balance sheet date.

This impairment loss creates a new cost basis by which future impairments are measured. This decline in cost basis cannot be restored by subsequent gains.

Issue stirs controversy

When Issue 03-1 was issued, many institutions expressed concern about the guidance on evaluating debt securities impaired solely because of changes in interest rates.

Of primary concern was the requirement for institutions to establish intent and ability to hold these securities to forecasted recovery.

This concern was compounded by a statement in Issue 03-1: Patterns of selling investments before forecasted recovery of fair value (though not presumptive) may call into question the investor's intent.

Many institutions were concerned these provisions would interfere with their asset/liability management practices by driving them to hold securities in loss positions to avoid tainting their intent to hold other impaired securities in the available-for-sale portfolio.

Institutions also were concerned Issue 03-1 did not provide guidance on the minimum severity of impairment that must be present to require documented intent to hold to recovery.

Concerns delay effective date

In response to concerns, FASB delayed the effective date of the evaluation guidance of Issue 03-1 pending additional deliberation.

In September 2004, FASB issued a proposed FSP, which indicates "minor" impairments caused by interest-rate increases can be considered temporary; however, the term "minor" is not defined.

The proposed FSP also provides narrow exceptions under which an institution may sell a previously designated impaired security before recovery without tainting the remainder of its portfolio.

These exceptions are primarily based on events previously unforeseen by the institution.

FASB received more than 240 comment letters, many from financial institutions, expressing nearly unanimous concern over proposed FSP guidance.

Where do we go from here?

FASB plans to continue deliberation of this issue in 2005. In the meantime, keep in mind:

- ▲ Issue 03-1 interprets existing accounting rules. FAS 115 currently requires institutions to evaluate their securities for other-than-temporary impairment and recognize any such impairment in a manner similar to realized losses.
- ▲ Issue 03-1 disclosure requirements, including information about severity and duration of impairment, have not been delayed and are currently in effect.

For additional information on the status and application of Issue 03-1, please contact your BKD Financial Services Group advisor.❏

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Industry trends & commentary

3rd quarter sees consolidation trend continue

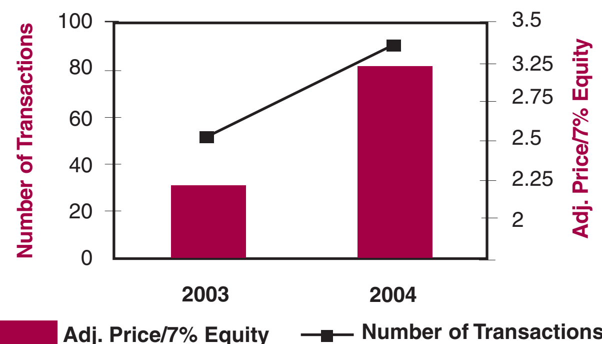
by Pat Hayes, BKD Corporate Finance, LLC, phayes@bkd.com

There have not been any mega-merger announcements recently; many larger institutions are still integrating their most recent acquisitions, but mid-sized to smaller banks continue the consolidation trend.

Compared to 2004's second quarter, the number of announced transactions in the BKD service area slowed just slightly from 34 to 28 during the third quarter; however, the 28 announced transactions bring the YTD total to 90, a dramatic increase over the 52 announced during 2003's first three quarters.

In addition, transaction multiples during the third quarter increased from 2.28 times adjusted price/7% equity during the second quarter to 3.22 times, which also was an improvement over the 2.47 times paid during the same quarter in 2003.

Obviously, if this trend of higher multiples continues, the number of transactions announced during the fourth quarter and beyond also should increase as more sellers will be enticed to take advantage of these attractive multiples.❑

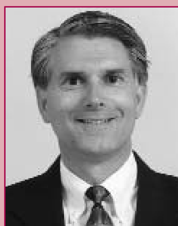


New name, same corporate finance solution

BKD, LLP's corporate finance subsidiary, BKD Financial, LLC, has changed its name to BKD Corporate Finance, LLC (BKDCF).

Founded in 1994, BKDCF has helped companies and stockholders create an estimated half a billion dollars in corporate value through mergers, acquisitions, sales, recapitalizations, management buyouts, employee stock ownership plans, financing and initial public offering advisory services.

BKDCF has helped companies buy, sell and divest in a wide range of industries, including financial institutions, communications, defense, construction, real estate, health care, manufacturing, technology and wholesale distribution.


Steve Blumreich

"A real benefit BKD Corporate Finance brings is in the sale of companies—the value to the seller can be dramatically enhanced through the methods we employ," says BKDCF President **Steve Blumreich**. "We've demonstrated this with many successful transactions, resulting in sales that exceeded the value expectations of our clients."

To find out more about BKD Corporate Finance, LLC, visit **www.bkdcorporatefinance.com** or ask your BKD advisor for an introduction.❑

BKDCF's sales solutions address complex issues, varying degrees of risk

BKD Corporate Finance has helped financial institutions work through the complex issues and risks related to a sale, among them:

- ▲ When is the right time
- ▲ What is the right value
- ▲ How is the transaction structured
- ▲ How does the process work
- ▲ How do key employees benefit
- ▲ How are buyers identified
- ▲ How is confidentiality maintained

Our corporate finance experience has been tested over time with many successful transactions, resulting in sales that exceeded the value expectations of our clients.

Transactions are structured to boost an institution's value through:

- ▲ Thorough analysis of the institution
- ▲ In-depth financial analysis to identify value within the institution
- ▲ Effective marketing programs to generate multiple buyers while maintaining confidentiality
- ▲ Expertise in structuring and negotiating transactions

For more information about our sales solutions for financial institutions or any of BKDCF's other services, contact your BKD Financial Services Group or BKD Corporate Finance advisor.❑