



Financial Alert

Management & Compliance Solutions
for Financial Service Organizations

September 2006

FAS 156 & servicing of financial assets

by John Garrott, jgarrott@bkd.com

In March, the Financial Accounting Standards Board (FASB) issued **Statement No. 156** (FAS 156), *Accounting for Servicing of Financial Assets*, which amends FAS 140 and permits institutions to choose to measure servicing rights, including mortgage servicing rights, using either of the following:

- ▶ Current amortization method, in which an institution amortizes servicing assets and liabilities in proportion to and over the period of estimated net servicing income or net servicing loss with fair value assessment of impairment or increased obligation as of each reporting date (lower-of-cost or market-value method)
- ▶ Fair value method, with servicing assets and liabilities measured at fair value on each reporting date and changes in fair value reported in earnings for the period the changes occur (mark-to-market method)

FAS 156 clarifies when a servicer should separately recognize servicing assets and liabilities. It also requires all separately recognized servicing assets and liabilities to initially be measured at fair value, if practicable, and requires additional disclosure for separately recognized servicing assets and liabilities.

FAS 156 is effective for all separately recognized servicing assets and liabilities as of the beginning of an institution's fiscal year that begins

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Small BHCs prepare for big changes

by Brian J. Mischel, bmischel@bkd.com

The Federal Reserve System's (the Fed) Board of Governors (the Board) adopted new capital and leverage guidelines for small bank holding companies, allowing approximately 85% of all bank holding companies (BHCs) to qualify for the guidelines, where only 55% were eligible before.

Effective March 30, significant changes under the new guidelines included the asset size and qualitative criteria used to determine (1) if a BHC may qualify as a small BHC and (2) the treatment of trust-preferred securities.

Who qualifies?

A BHC now qualifies for small BHC status if its consolidated assets are less than \$500 million; it will fail to qualify if any of the following apply:

- ▶ It engages in significant nonbanking activities, either directly or through a nonbank subsidiary.
- ▶ It conducts significant, off-balance-sheet activities, including securitization or managing or administering assets for third parties.
- ▶ It has a material amount of debt or equity securities outstanding that are registered with the Securities and Exchange Commission (SEC).

Risk-based capital guidelines were adopted by the Board in 1989 to assist in the assessment of a BHC's capital adequacy. Before the new guidelines, BHCs with \$150 million or more in assets were subject to the Fed's consolidated-capital rules.

To be deemed well capitalized, such institutions must maintain a (1) 5% leverage ratio, (2) 6% tier I to risk-weighted assets ratio and (3) a 10% total capital to risk-weighted assets ratio on a consolidated basis.

Requirements for small BHCs

Small BHCs are not subject to the con-

solidated capital rules. The Fed will consider a small BHC's leverage ratio only on a parent company basis and will consider the adequacy of the bank's capital on a bank-only basis.

More importantly, the new guidelines permit the formation and expansion of small BHCs with acquisition debt levels higher than what are permitted for larger BHCs. Qualifying small BHCs may use debt to finance up to 75% of the purchase price of an acquisition (debt-to-equity ratio can be up to 3:1), subject to ongoing requirements:

- ▶ Reduce parent company debt in such a manner that all debt is retired within 25 years of being incurred
- ▶ Reduce debt-to-equity ratio of .30-1 or less within 12 years of the debt being incurred
- ▶ Ensure each of its subsidiary insured depository institutions is well capitalized
- ▶ Refrain from paying dividends until it reduces its debt-to-equity ratio to 1.0:1 or less

Changes & their impact

The treatment of trust-preferred securities has changed under the revised guidelines. Before the changes, subordinated debt issued in connection with trust-preferred securities was not treated as debt for small

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Increase value before selling

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

Many bank owners don't adequately prepare for the sale of their banks. Lack of preparation can cost owners a great deal at closing. As with any important decision, readiness is vital. If you are considering selling your bank in the next five to 10 years, lay the groundwork now. The following nine ways—not listed in order of importance—can help you develop and implement a strategy for increasing its value.

Think like a buyer - Put yourself in the buyer's shoes. If you were to buy your bank, what would concern you? Looking in the mirror can be enlightening, as most bank owners are focused on day-to-day operations and may need to consider their bank more objectively and comprehensively.

Mold a strong management team - If buyers view your involvement as vital to the bank's success, you will either be forced to stay on after a sale, or the value may be reduced. Identify key employees to groom as leaders in your stead. This includes transferring any relationships with major customers to other qualified personnel. In the buyer's eyes, this will help lessen the risk of negative perceptions about your exit. A buyer should feel your departure will be a seamless transition and not create a leadership void.

Clean up the loan portfolio - A common

method buyers use to reduce the purchase price is through the loan portfolio. Without adequate loan loss reserves or with loans on the books that should have been written off, the buyer perceives an opportunity to decrease the original offer. If you increase your reserves, you not only appease regulators, you may also prevent a buyer from lowering the purchase price because of a perceived shortfall.

Invest in the future - Many owners believe decreasing certain expenses will pay off with a higher purchase price by inflating earnings.

However, avoiding needed improvements, information technology upgrades or

new equipment purchases can negatively affect value. Also, appearances *do* matter in a transaction. Dilapidated equipment or facilities in need of maintenance or updates diminish the bank's overall impression.

Controlled ownership - Buyers prefer to purchase 100% of a bank from a small number of like-minded owners. In many cases there may be minority owners who may not have the same objectives as majority owners. Buying back the minority owners' shares well in advance of a sale may ensure a smoother transaction and may increase value. If such a buyout is not feasible, then it is important to obtain their agreement to sell. Without a unified position, the sale of a closely held bank is not only difficult but may also be impractical.

Pruning - If your bank has multiple branches, it might make sense to sell one or more of the branches before selling the entire bank. If your branches are spread out geographically, a potential buyer might discount the value because of the difficulty in managing the operations or force you to retain a branch not located where the buyer envisions growth. An underperforming branch might reap higher value in a separate transaction, yielding funds you could put to better use elsewhere.

Timing - Timing has a significant impact on value. An underperforming bank may sell for more in an up market than a high-performing bank does in a down market. Too many bank owners decide to sell based on their age or an

unexpected event, rather than basing their decision on the overall business climate. An experienced intermediary can help keep you informed about industry and market conditions and when it is the right time to sell.

Pool of buyers - Too many times, owners assume they know who the buyer will be. Such transactions often take place, and everyone walks away happy, especially the buyer. But without adequate competition, a single potential buyer will not be forced to make his/her best offer because no one else outbids in the process. When it is time to sell, make sure your advisor performs a broad marketing

campaign to attract potential buyers you may not be aware of, but who may be looking for a bank just like yours.

Multidisciplinary team of advisors - Choosing the right investment

banker is one of the most important decisions you will make in enhancing the value of your bank. An investment banker with transactional experience can educate and prepare you and your bank for every aspect of the sale process. This advisor manages the transaction from start to finish, ensuring a smooth process that allows the owner to focus on managing the business.

Selling a bank is a team effort. In addition to the investment banker, a solid team of advisors includes a CPA, financial advisor, merger and acquisition attorney and estate planner. Evaluate each team member for the right training and experience, along with a high degree of integrity and professionalism.

For most owners, selling their bank is a once-in-a-lifetime opportunity. Be sure you are fully prepared to sell at the right time and receive top dollar in the transaction.

BKD Corporate Finance, LLC, a wholly owned subsidiary of **BKD, LLP**, provides corporate finance services, including mergers, acquisitions, sales, recapitalizations, management buyouts, ESOPs, financing and IPO advisory services. Contact your BKD Financial Services Group advisor for an introduction to BKDCF. ■



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after September 15, 2006. Earlier adoption is permitted if the institution has not already issued interim financial statements during the fiscal year.

For institutions with a calendar year end, FAS 156 will be effective January 1, 2007.

FAS 156 contains new options and issues that may have a significant impact on your institution's financial statements. Contact your BKD Financial Services Group advisor for more information. ■

TEFRA disallowance update for S corporation banks

by Doug Born, dborn@bkd.com

On August 24, 2006, the Internal Revenue Service (IRS) issued proposed regulations it believes will clarify the TEFRA (*Tax Equity and Fiscal Responsibility Act of 1982*) interest disallowance issue for S corporation banks for years beginning on or after August 24, 2006.

Proposed regulations

The proposed regulations state that nothing in the rules of IRC section 1363(b)—which has to do with computing a corporation's taxable income—prevent tax code rules that apply to banks from also applying to banks that have elected S corporation status.

But Section 1363(b)(4) states the taxable income of an S corporation shall be computed in the same manner as in the case of an individual except that Section 291 shall apply if the S corporation was a C corporation for any of the three immediately preceding taxable years.

It appears that the proposed regulations may be in conflict with the statute. You have until November 22 to comment on these proposed regulations.

Applying TEFRA disallowance

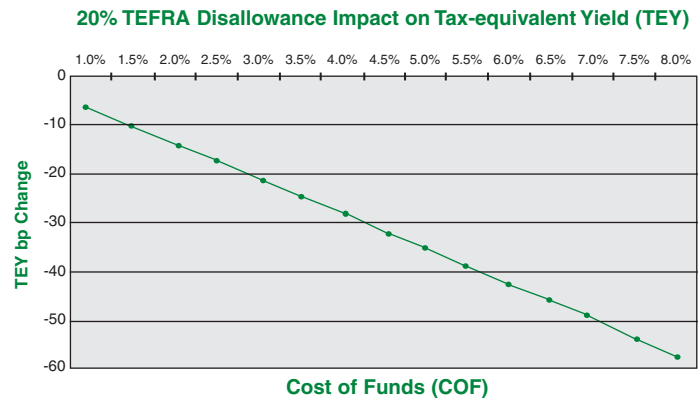
Therefore, beginning for tax years that begin on or after August 24, 2006, IRS guidance states TEFRA interest disallowance continues to apply to an S corporation bank identical to the rules that apply to a C corporation bank.

If the regulations become final, tax returns filed for 2007 will likely need to do one of the following:

- ▶ Consider this new guidance and calculate taxable income accordingly
- ▶ Disclose if a contrary position is taken (by filing Form 8275-R with their tax return)

Even though the proposed regulations are not effective for 2006 or earlier calendar-year taxpayers, they do provide the written guidance many tax practitioners expected. Discuss your plans to use these regulations for your 2006 tax returns (due in early 2007) with your BKD advisor. **You will also need to consider amending prior affected tax returns: Any returns not amended carry additional tax exposure for the shareholders of the bank.**

Your S corporation bank must consider this new development in analyzing all future municipal purchases. A review of the taxable equivalent yield of current municipal holdings should also be considered. ■



New rules on ODP changes take effect

by Sean Kulczycki, skulczycki@bkd.com

Effective July 1, bank overdraft protection (ODP) programs will be affected by significant changes to Regulation DD (*Truth in Savings Act of 1991*). Their impact on your financial institution largely depends on whether it has an ODP program and if it is promoted. However, even institutions that don't offer ODP programs will be affected to some degree.

Promoting your ODP program

Institutions that continue to promote their ODP programs will be most affected by the changes to Regulation DD because they will be required to provide detailed disclosures on overdraft fees on each periodic statement.

Disclosed information must include the total dollar amount of fees or charges imposed for overdrawn accounts and the total dollar amount of all fees imposed for returning items unpaid. You must provide this information for the statement period and the calendar year to date, beginning with the first, full statement cycle after July 1, 2006.

Promoting an ODP program or policy is when you advertise or publicize it through broadcast or print media (including informational brochures), Internet sites, billboards or indoor signs. It also includes messages printed on periodic statements or ATM receipts or those appearing on an ATM screen or other automated system like a telephone response machine. If your institution engages in any of these practices, it must provide the overdraft fee disclosures on its periodic statements.

When promoting the payment of an overdraft in an advertisement, additional disclosures are now required, including:

- ▶ The fee for the payment of each overdraft
- ▶ The categories of transactions for which an overdraft fee may be imposed
- ▶ The time period in which the consumer must cover any overdraft
- ▶ The circumstances under which the institution will not pay an overdraft

Canceling promotional efforts

Many institutions have elected not to promote their ODP programs, which means they don't have to include overdraft fee disclosures on periodic statements. These institutions must be careful not to reference their ODP programs in any information that is publicly available or provided to customers.

Despite its best efforts, if a bank inadvertently promotes its program, Regulation DD requires it provide the periodic statement disclosures for that account for two years after the ODP program was last promoted.

Updating initial disclosures

Your institution may not offer an ODP program, but you're not entirely in the clear. Regulation DD changes require *all* financial institutions to update initial Truth in Savings disclosures by specifying the transaction categories where an overdraft fee may be imposed.

Fortunately, the Federal Reserve Board provided model language, indicating it's suffi-

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Mark your calendar

At 10 a.m. (CST), September 21, join Sean Kulczycki, BKD senior managing consultant, as he hosts **An Inside Look at BSA & the Community Bank**, the first in a series of BKD-produced webcasts for the financial services industry.

When the Federal Financial Institutions Examination Council released the **Bank Secrecy Act/Anti-Money Laundering Examination Manual** (the BSA/AML Manual) June 30, 2005, it prompted many community banks to independently review their BSA programs.

BKD has conducted many such reviews, gaining valuable insight into how community banks have responded to the BSA challenge. Kulczycki, a certified regulatory compliance manager, says the webcast will cover:

- ▶ How community banks have responded to key BSA issues, including risk assessments, customer due diligence and monitoring and reporting suspicious activity
- ▶ What Federal bank examiners expect, criticize, recommend and ignore
- ▶ Best practices for dealing with BSA/AML expectations
- ▶ Common exceptions observed during the independent review process

John Bourquard, BKD principal, will host the series' second webcast, **Improving Your Bank's Credit Quality**, scheduled December 7 at 10 a.m. (CST). Mr. Bourquard has 22 years of experience working with banks and leads BKD Risk Management Group's loan review and credit quality consulting practice. ■

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cient for an institution to simply state the fee applies to overdrafts "created by check, in-person withdrawal, ATM withdrawal or other electronic means."

Overall, the changes to Regulation DD are proving to be complicated and filled with nuance. BKD suggests your financial institution conduct a thorough review of the way it markets its ODP program and evaluate if ODP program balances or other information is provided at ATMs or on periodic statements. This is particularly important for institutions that have elected not to promote their program. ■

Small BHCs prepare for big changes. . .

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BHCs. The new guidelines provide that the subordinated debt associated with trust-preferred securities is considered debt for most purposes.

Such subordinated debt would be included as debt in determining whether a qualifying small BHC's acquisition debt is 75% or less of the purchase price, and a qualifying small BHC's debt-to-equity ratio is greater than 1.0:1. However, subordinated debt associated with trust-preferred securities would not be included as debt in determining compliance with the 12-year debt reduction and 25-year retirement requirements of the revised guidelines.

To level the playing field for small BHCs and those that are larger, the Fed will allow a qualifying small BHC to exclude from debt an amount of subordinated debt associated with trust-preferred securities equaling up to 25% of the small BHC's stockholders' equity less parent company goodwill.

The Fed provided for a five-year transition period for issuances that pre-dated December 31, 2005, until December 31, 2010.

Changes affecting small BHCs will have an extensive impact on community banks, and applying the new guidelines will be significant in acquisitions and capital needs to support growth. Contact your BKD Financial Services Group advisor for more information. ■

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