

POSSIBILITIES

INSIGHTS FOR FINANCIAL INSTITUTIONS

OCTOBER 2011



Conversation with Richard Westra

Possibilities recently sat down with a leader in the banking industry, Richard Westra of Dacotah Bank, to hear his thoughts on the state of the banking industry and where it's headed.

POSSIBILITIES: How do you see the current state of banking?

Westra: In South Dakota, things have been quite good—we only had one bank failure in recent years. We did not experience home foreclosure issues like other areas. It's my understanding, 50 percent of home sales across the country are taking place on foreclosed properties, and 25 percent of homeowners owe more money on their homes than they're worth. We don't see that around here, and this is certainly a challenge for other banks.

The industry is slowly recovering from the 2008-09 crises. We've been able to shed some loan losses and we're seeing improved capital ratios and earnings. That's not to say we'll return to enjoy pre-2008 levels, but we are seeing improvements in performance ratios in the past year. In the Dakotas, we saw some deterioration in loan quality in larger markets; this has not gotten worse. In fact, we're seeing recovery in loans in those markets.

Agriculture has been a benefit for banks in the Dakotas; ag-based balance sheets have been good for most institutions. The industry will still see more failures in 2011, but not at the pace we have seen in the past two years.

POSSIBILITIES: What do you see as the major issues faced by community banks today?

Westra: The word "survival" comes to mind. There's no question, we're going to continue to see fewer banking charters in the years ahead, as acquisitions and consolidation of charters take place. Smaller banks find it difficult to properly staff compliance departments to handle the massive quantity of new rules and regulations. First, the regulations need to be understood, then we have to determine how to comply. Another issue is technology. More and more customers find e-banking acceptable, via phone or other devices that do not require a brick and mortar presence in communities. Despite these issues, I am still pro community banks—they play an important role in the growth of our country, and will be key to growing the economy.

Some in the industry will say if you're a small bank, you better start thinking big. I'm not so sure that's proper thinking in every aspect

Richard Westra—continued on page 7



ABOUT RICHARD 'DICK' WESTRA

Richard began his career at the Federal Deposit Insurance Corporation in the Twin Cities, examining banks in Minnesota and South Dakota, before becoming associated with Dacotah Bank in 1973. In 1980, he accepted the position of president of Dacotah Bank in Aberdeen. On Jan. 1, 2008, Richard assumed the additional role of president and CEO of Dacotah Banks, Inc. (holding company), and the responsibility for day-to-day management of all areas of the company.



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Capital Planning

Community banks are accustomed to monitoring and measuring bank capital. As a highly regulated industry, banks regularly manage capital ratios to maintain the well-capitalized thresholds outlined in the Federal regulatory pronouncements. Because deposit insurance premiums are impacted by bank capital ratios, banks prudently strive to maintain capital ratios at the levels that minimize operating costs, and maximize the return to shareholders.

Capital planning is an important part of any merger and acquisition (M&A) initiative. M&A planning typically includes capital projections at both the bank and bank holding company levels, as regulatory approval is dependent on adequate capital. Capital planning is also important for banking organizations that have participated in the TARP Capital Purchase Program or Small Business Lending Program to insure the ability to repay the funds prior to the acceleration of operating restrictions or cost of funds. Capital planning is vital to planning for an S corporation election for a bank organization and the related dividend planning. Capital planning is typically required as part of a bank regulatory order.

Bank regulators understand that maintaining a strong capital position in the banking system is key to the preservation of the banking system through the ups and downs of economic cycles. It also provides the investor with confidence that fosters economic growth. Maintenance of strong capital ratios allows banks to overcome the short term crises. The Dodd-Frank Act included provisions for more stringent capital requirements for large banks and large bank holding companies. The Federal bank regulators participated on the Basel Committee on Banking Supervision which resulted in the development of Basel III international capital standards and will likely influence the U.S. capital standards for community banks in future years.

Banking regulators are embracing initiatives to strengthen bank capital standards. A recent example is the OTS memorandum issued on March 12, 2011, regarding capital management. The OTS memorandum outlines the capital planning process it expects savings associations to utilize in the management of their institutions. The memorandum defines what should be included in capital planning and risks that should be considered in the process. It also specifies stress testing should be a part of the capital planning process and how to incorporate stress testing in the capital management process for various sizes of institutions. The OTS memorandum is available on the OTS website at www.ots.treas.gov/_files/25380.pdf.

While the other bank regulators have not issued similar guidance on capital planning, it is apparent in communications with bank regulators that “raising capital as needed” will not suffice as a capital plan in situations when a plan is required. Capital plans are required to be more comprehensive documents that include long-range financial goals, annual goals to achieve the long-range goals and a business plan. The business plan should include financial projections reflecting the ability of the bank to achieve the long-range financial goals.

In addition, bank regulators are likely to expect financial institutions to utilize stress testing to help ensure the adequacy of the capital plan and to reveal vulnerable assumptions. For most community banks, the stress tests will consist of “what if” scenarios to assess the impact on earnings and capital of various risks a bank is likely to face. Those risks may include a variety of operational and environmental factors, such as a sudden increase in market interest rates, an increase in defaults on variable rate loans due to an increase in market rates, additional losses on OREO, a change in core deposit or loan growth, or other factors specific to the operation and business plan of the financial institution.

The stress test exercise will usually identify weaknesses in the bank’s business plan and require the development of contingency plans to address the risk. In many cases, holding additional capital may be sufficient to protect against the risk. In other cases, a change in dividend policy, a holding company line of credit to provide a capital contribution or some other plan to raise additional capital might be necessary to address the identified vulnerability.

Financial institutions that work through the capital planning process will be in much better position to weather the stress of an unfavorable business cycle and take advantage of the opportunities available at such times. They are also more likely to identify potential problems earlier, which will allow them to implement strategies to prevent the deterioration of bank capital levels.

If you have questions about capital planning, please contact your Eide Bailly representative. ■



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Year-End Tax Planning for Community Banks

As the seasons change and the end of 2011 quickly approaches, now is the time to consider tax planning strategies to maximize the tax efficiencies of your bank and help preserve shareholder investment value. This past year continued to be very challenging for the banking industry. Even with the business and profitability challenges faced by community banks today, it is still important to emphasize tax planning strategies that optimize the tax efficiencies for financial institutions in 2011.

Several beneficial tax provisions passed by Congress in the last few years are set to sunset after 2011, and due to the current political climate, these provisions may not be renewed. Your financial institution may want to be sure certain transactions and purchases close by the end of 2011, in order to utilize some of these expiring provisions, a couple, of which, include:

Enhanced IRC Sec 179 Expensing and 100 Percent Federal Bonus Depreciation

Purchasing needed furniture, equipment, computer equipment and software could provide a substantially enhanced tax deduction, if purchased prior to December 31, 2011.

For 2011, the amount of qualified property that can be directly expensed under Section 179 is currently \$500,000 annually. In addition, the beginning of the phase-out range (which reduces the \$500,000 expense limitation) for total additions of qualified property is \$2 million. It is important to note, the Section 179 deduction is limited to the amount of taxable income, so corporations with taxable losses in the current year would not be able to take the Section 179 deduction. For S corporations, wages of employee-shareholders can be added back to taxable income for purposes of determining this taxable income limitation.

Section 179 can also be taken on specific real property for the 2011 tax year, up to \$250,000 of the total Section 179 expense taken for the year. Items, such as certain leasehold improvements, could qualify for the Section 179 deduction in 2011. Remember, the provision allowing certain real property eligibility for this accelerated deduction expires after the 2011 tax year.

In addition, regarding the 2011 tax year, the Internal Revenue Code provides for bonus depreciation of 100 percent for the cost of eligible tangible personal property that generally has a depreciable life of 20 years or less, that was purchased and placed in service prior to January 1, 2012. Thus, this special bonus depreciation allowance will not exist for assets purchased after December 31, 2011, so adding needed fixed assets prior to that date would optimize their after-tax cost. This special bonus depreciation is not limited to taxable income like the Section 179 deduction.

If the bank has built or is in the process of building a new bank building, a cost segregation study should be considered. The study identifies assets that are typically classified as part of the cost of the building (and depreciated over 39 years), and reclassifies them as property eligible to be depreciated over shorter lives, which could potentially take advantage of the 100 percent bonus depreciation provision.

Work Opportunity Tax Credit (WOTC)

The WOTC provides employers who hire members of certain targeted groups to receive a credit against income tax of a percentage of first-year wages up to \$6,000 per employee (certain categories of employees could provide a differing wage base). Generally, the percentage of qualifying wages is 40 percent of first-year wages, up to the \$6,000 general maximum wage base; it's 25 percent for employees who have completed at least 120 hours, but less than 400 hours of service for the employer. The term "wages," for WOTC purposes, does not include any amount paid or incurred for an individual who begins work after Dec. 31, 2011.

Please contact your Eide Bailly tax professional to help implement year-end tax planning strategies and to utilize these beneficial expiring tax provisions.

An extended version of this article can be found on our website, www.eidebailly.com/industries/financial-institutions. ■



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Customer Service vs. Customer Security

Where to Draw the Line?

Internet and phishing scams have made the world a much riskier place for banks trying to protect their reputations and customers. Common security practices are easily defeated by phishing and social engineering. How do fraudsters target your customers and your institution? Why can't you recover the money? Why won't your insurer pay for the loss?

Three Little Banks and the Big Bad Wolves

True or False: A stranger can route phone calls from your home or cell phone directly to the stranger's disposable cell phone and you won't even know it's happened.

TRUE. As three small institutions in Iowa found out last December, it's very true. It cost them more than \$2 million and a lot of embarrassment. They were victims of a scam perpetrated throughout the United States, costing banks and/or their customers millions.

The big bad wolves, our crooks, look for high profile individuals like doctors, dentists or developers. Spear phishing, phishing of data on a targeted individual or company, can take many forms, such as pretext phone calls or spoofed e-mails. Wolves gather all available data on their targets, including where they bank. One wolf phones a customer's bank and pretends to be that customer. Because of personnel turnover, the

odds are in the wolf's favor that he will speak with someone on the phone who doesn't know the customer.

The wolf begins his tale: "I'm out of the country on a business trip. I need to wire \$400,000 to an overseas bank. I'll provide the details to you later in an e-mail. Contact me via that e-mail address. Cell phone service here is unreliable, so I prefer to be contacted by e-mail."

Every bank touts their customer service, but, banking customer service is designed around easy access. Our customer service representative, let's call her "the lamb," isn't going to irritate a valued customer. So, she asks the wolf a few questions to ensure she is talking to the customer. The bank's security procedure requires it, right? The wolf probably suppresses a snicker. He knows you're not really a secure bank. You are prey, and he's about to eat you.

What are the security questions? Background information, of course! The very same background information the wolves have been data-mining or spear phishing. The lamb asks, "What is your social security number? What is your date of birth? What is your mother's maiden name? What is the address on the account?" The wolves already have this information, or they wouldn't have called.



The lamb receives the e-mail from the wolf. The wolf wants the money sent to a bank in a country other than the United States.

The lamb reminds the wolf that the bank's security policy requires someone to be present at one of the contact numbers listed on the customer's wire transfer agreement. Often, the lamb will tell the wolf what that contact number is. After all, the wolf is a valued customer.

The wolf contacts the customer's telephone service provider in close proximity to where the wire is expected to take place and pretends to be the customer. The wolf tells the provider that there is a problem with his phone and needs all calls routed to his cell phone. The provider says, "No problem, we get thousands of requests like this every day. But first, let me ask you a few verification questions. What is your social security number? What is the address where the service is located?"

Sound familiar?

Of course, the wolf knows the answers. The calls are forwarded. The banker dials the correct wire verification telephone number. It goes directly to the wolf's cell phone and the banker doesn't know it. The banker has done his part for security. The wire is sent.

On the other end of the world, the wolf pack withdraws the money as soon as it hits the account. Many countries do not have restrictions on withdrawals either, in form or amount. The money becomes as untraceable as a raindrop in the desert.

Eventually, the customer realizes a lot of money has been transferred out of his account and calls the bank. Bankers question whether or not their security is adequate or whether the customer was too loose on the Internet with personal information. The customer threatens a lawsuit, and the bank contacts its insurer. The insurer asks for proof of what took place.

Here are some of the problems:

1. Conversations between wolves and bankers that are not electronically recorded will not be admissible as proof. Recording all calls is expensive, and many small or mid-size institutions don't think they need it. Know what your insurance policy requires.
2. Disposable cell phones are a wolf's second best friend, after the Internet. They require no identification and the number can be disguised as coming from any area code, including your local one. Any of the wolf's phone numbers or e-mail accounts will not be operable as soon as the money is wired. They are as disposable as a diaper.
3. There are many ways of obtaining information on a high profile individual or small business. One ploy is for the wolf to pretend to be a business that wants to do business with the company but can only do business via wire transfer or ACH transfer. The wolf asks for the banking information, and someone at the company, who hopes to win the big sale, provides it. Another way is businesses use multiple computers for their banking activity and do not have restrictive policies in place. An unsuspecting employee visits a website and spyware is downloaded to provide a wolf with the company's information.
4. Banks **must** follow their own procedures. If the wire agreement states the customer and bank must agree on a password to be used for any wire transfers, do it. Not following your procedures is fodder for lawsuits and nonpayment decisions by insurers. ■

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THE DIRECTORS' CORNER

Board Self Assessment Considerations

Self-assessment is an important tool to improve the effectiveness and efficiency of a Board of Directors, and must address the views of your community, shareholders, regulators, employees and members of the Board itself. Board self-assessments should not only be an exercise to meet regulatory expectations, but add value to your company and enhance your role as a director. It helps to reinforce the roles and responsibilities of the Board, highlight what areas need to be prioritized or enhanced, and is a good partner to the strategic planning process.

The effectiveness of the Board is critical to the value and strength of a financial institution and its holding company. Self-assessment assists directors seeking to improve the efficient and effective use of their time and skills by encouraging individual and group self-reflection. The Board may examine its performance against standards of best corporate practices, including:

- Responsibilities and accountability of the Board
- Board terms
- Director independence
- Board structure and organization
- How the board functions
- Board committees
- Responsibilities and skill sets of individual directors
- Director involvement
- Director expertise
- Director integrity
- Standards of performance
- Board oversight

In recent years, some of the biggest, most sophisticated financial institutions failed on a number of levels. Boards, especially of public companies and financial institutions, are under increasing pressure to enhance performance and corporate governance. Directors are held to a higher degree of accountability by Congress, regulators, shareholders and the public.

If a Board has a record of self-reflection, identifies areas of improvement and acts to implement improvements, it shows a pattern of careful attention that will likely reduce regulatory criticism and litigation risk. Documentation of these issues does not have to consist of detailed criticisms, however, for self-assessment to be complete, follow-up is mandatory. The process should not create a report of evidence of failure or poor performance; should avoid numeric or check-the-box grading; should use short record retention periods; and should not take a negative tone.

The Board self-assessment process must be a product of the directors, especially the independent directors. If management

plans the process, the review will likely miss areas of special concern to directors. Every director must be involved in the planning, conduct and follow-up stages of the process. Though directors should lead the process, the use of a third-party facilitator can be beneficial. Candor and focus often increases with a neutral third-party acting as an interviewer and moderator. Boards should decide the most appropriate timeframe for conducting assessments. If there are no issues requiring review, then regular assessments every 18 to 24 months, rather than every 12, may be more appropriate.

Directors and planners should select three to five issues per session; consider:

- Board Composition (expertise, skills, independence, training)
- Board Information (Board packages, useful and necessary information, industry trends)
- Business (CEO evaluation, risk management, strategic planning)
- Meetings (timely actions, executive sessions)
- Board Interaction (personal dynamics, working as a team, relationship with employees)
- Board Accountability (prepared, understanding, effectiveness of structure)
- Committees (role of committees, who participates)
- Other (Board succession, industry issues, compensation)

Self-assessment sessions should take a different tone than regular board meetings. Good self-assessments must be meaningful, practical and engaging. It needs to be a hard, honest look at the Board, not a mere validation of existing practices. If well-designed, the process can improve the Board's function and value to the company, while, at the same time, reduce the directors' exposure to potential liability. ■



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of our business. Many products and services we provide work best if we operate under the concept of the bigger you are, the smaller you need to think. We've been particularly successful in our institution by delivering the products and services our customer want with as much service as possible. We're no different than a retail operation—we sell service.

POSSIBILITIES: Community banks have experienced a drastic increase in regulatory demands; are you seeing improvements?

Westra: There's no question, regulatory demands continue to increase. The demands placed on financial institutions today require significant investments in new software and specialized skills, often which need to be acquired on an outside fee basis to comply with the information and processes requested. Data warehouses, for example, have to be comprehensive and complete. Economic data must be kept current. Forecasting and planning is more important than ever before, as is stress testing and, what I would call, futuristic "what-if" scenarios. It's no longer satisfactory to simply look back at what has happened since the last exam; instead, look ahead to where the institution is headed. Does it have the controls, capital and personnel necessary to safely get from point A to point B?

POSSIBILITIES: How do you anticipate Dodd-Frank will affect community banks?

Westra: This huge piece of legislation is more than 2,300 pages long. It has 243 references to new required regulations; 67 references to new required studies to be conducted; 22 references to new required reports to federal agencies. It also created a new agency, the Bureau of Consumer Financial Protection. We'll have a better understanding once the new regulations are all out, after all required reports are finalized and all studies have been completed. I would anticipate this will take five or more years. Dodd-Frank targeted the larger, systemically important institutions that had the most impact on the financial crises. Community banks had little to do with the crises, yet, will certainly feel the impact.

Looking at the positive, FDIC insurance reform was a positive outcome. The Act increased protection to \$250,000, and non-interest accounts are fully insured through 2012. Also, assessment base changed—it's now based on assets minus tangible equity, which has been helpful to community banks.

The Act attempted to carve-out smaller institutions in some respects. For example, the Durbin Amendment (regarding interchange income banks receive on debit card transactions) aimed to shift costs away from merchants to banks. However, the carve-out for small banks under \$10B is really unworkable. Visa and MasterCard have a two-tiered rate structure—this will, no doubt, bring price compression, as merchants are now empowered to route transactions to the network of their choice, and surely they'll choose the cheapest route. As a result, we may see a detrimental impact.

POSSIBILITIES: As president and CEO of a high performing bank, what factors do you feel are critical to the success of community banks?

Westra: I've been in banking for more than 40 years, and have never seen a more challenging environment for both community banks and the entire industry, including in the 80s when we saw record high interest rates. I believe a key factor to success is a banker's willingness to accept change. We need to adjust to our environment. At the same time, don't abandon your culture and the services and products that got you to where you are today. Deliver products and services aligned with how today's generation wants their services delivered. Hang on to a concept of service and keep delivery close to your consumers' needs.

Keeping a proper earning asset mix will be critical going forward. We need to keep up good loan volumes. Loan volume has softened in recent years, in spite of historic low interest rates. For community banks' continued success, they need to be relieved of the massive regulatory burden. More and more dollars are spent every day to address compliance questions, which leaves fewer dollars to devote to our

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communities. If banks are to grow and prosper in the future, maintaining adequate capital levels is key.

POSSIBILITIES: Can you reflect on your role as a Federal Reserve Bank board member? What has been significant?

Westra: The role of a director is to act as an informed source on business opinion and regional economic activity and trends within a district. A director's grass roots information as to how things are going remains an important part of the federal decision-making process. We provide information to reserve bank presidents who participate in board of governors' meetings in D.C. We serve on a variety of committees within banks, approve an annual budget and provide management oversight of bank operations.

During my term, I began to fully appreciate that my bank has markets in the Dakotas.

We've largely been isolated from the majority of our country's problems. Adjacent states have experienced significantly more foreclosures, default rates and unemployment. I believe the deeper the problem, the more difficult it will be to fix, and usually, there is no quick fix. What worked in the past may not work again.

I think this country, and the world, came very close to a total economic collapse in 2008. It was saved by quick and decisive acts by our central bank and government. The recovery has been slow; housing has not recovered; the country's deficit has not been adequately addressed; and the economy continues at a snail's pace. Doing nothing is not an option. I sincerely hope those in D.C. will address these vital issues. It's time to come together. ■

Special thanks to Richard Westra for taking the time to talk with Possibilities.

31st Annual Bankers Seminars

Thursday, October 27
Fargo, North Dakota

Thursday, November 3
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Thursday, November 17
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