

POSSIBILITIES

INSIGHTS FOR FINANCIAL INSTITUTIONS

JANUARY 2012



Conversation with Kevin Murphy

Possibilities recently sat down with a leader in the banking industry, Kevin Murphy, Deputy Commissioner of the Minnesota Department of Commerce's Financial Institutions Division, 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?

Murphy: There are various levels in the banking industry. The big domestic banks and the European banks are still in the headlines every day. The news media are writing about rating agency downgrades and there are concerns that the European countries' financial difficulties might spill over and have an effect on U.S. institutions. Major banks are facing more stress tests by the Federal Reserve System. Overall, big league banking is a little bit cloudy.

As far as community banks in Minnesota, the current situation is rather mixed. Our watch list of 3, 4, 5 rated banks is currently around 109 out of a total of 300 banks – or 36% of the state banks. Of the 109, 52 are 4 and 5 rated. So, a fairly significant percentage of the banks are on the watch list. The total is down slightly from 2010 year-end and seems to have stabilized. I think most of the deterioration

has stopped, but we remain at historical highs for the watch list. Three years ago we had only 51 on the list. Looking at bank data geographically, there are 38 state banks in Hennepin and Ramsey counties – their aggregate return on assets (ROA) through June 30, 2011, was .13, which is pretty low. The ROA for the 62 banks in the surrounding suburban counties was only .22, which is also low as compared to outstate banks, whose aggregate return on assets ranged from .80 - .90. Looking at another measure, the allowance for loan and lease losses, the metro banks were at 2.7% of loans while outstate banks were at 1.8%.

Overall, outstate banks in the aggregate are currently doing better. We need to keep in mind though, that a fair number of banks, including many in the Twin Cities, are doing very well despite the economic difficulties.

POSSIBILITIES: How many banks have failed?

Murphy: Since 2008, we've had 17 bank failures in Minnesota. Four of those were national banks, the rest were state banks. Four of them were relatively new banks, which I measure as less than 12 years old. The average size was \$100 million, and if you take out

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ABOUT KEVIN MURPHY

Kevin Murphy's prior experience includes 17 years with the FDIC and 13 years as a private sector banking consultant. His FDIC experience includes 10 years as a bank examiner in the Midwest and New England, three years at FDIC headquarters in Washington, D.C., and three and a half years as assistant regional director of the FDIC's Minneapolis Regional Office. At Commerce, he was responsible for the direct management of the examination and licensing programs for state-chartered financial institutions, insurance companies and consumer credit companies and supervision of the division's staff of 65. Kevin retired from the Department of Commerce in December 2011.



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Enterprise Risk Management for Financial Institutions

Individuals at financial institutions are having robust discussions about how an Enterprise Risk Management (ERM) process could add value to their organization. Some financial institutions have found ERM is a necessary element to provide regulators with information for their response to existing and emerging risk. Many are also linking ERM to strategic planning to optimize opportunities.

When considering the implementation of an ERM process, one of the first steps is to adequately assess your current risk management practices. Eide Bailly utilizes the Financial Institutions Risk Universe to help clients understand their current risks from a holistic perspective. What are the internal and external risks your institution faces on a daily basis? How do you currently react to those risks?

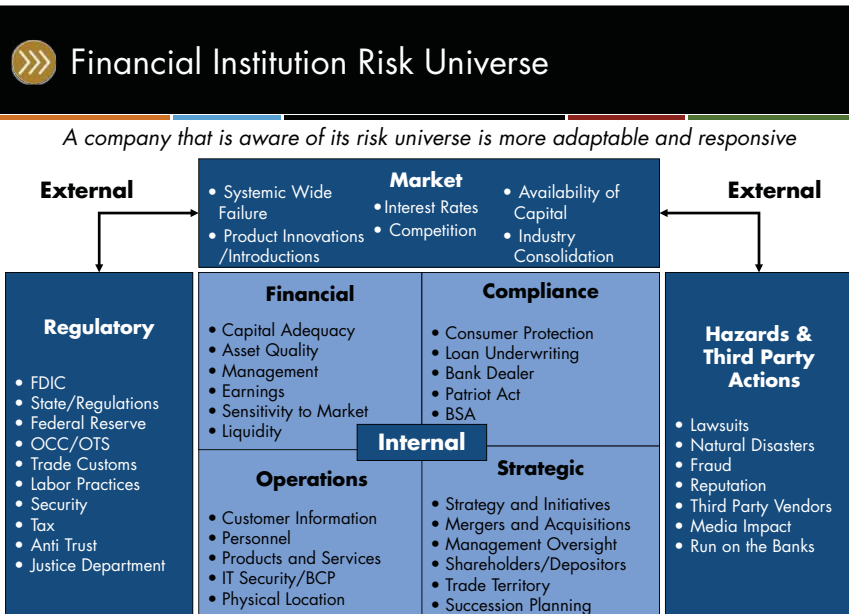
Internal risks can typically be compartmentalized into four categories: financial, operations, governance and strategic. These risks are relatively easy to identify. It also is easy to develop effective controls around internal risks. Strategic risks, such as mergers, acquisitions and strategic planning are rarely linked together. Traditional risk management efforts can be largely silo driven, focused on mitigation and are not tied to strategy in any meaningful way.

It is rare to have control over external risks, but the reaction to them may propel an institution forward or cause them to falter. Developing risk response plans allow institutions to be prepared when unexpected events or unintended consequences occur. A broad or enterprise view of risks will provide the

opportunity to look at multiple options of mitigating, managing, transferring and ultimately exploiting opportunities.

As a result of the ERM process, institutions are provided with the tools to control their risk response and focus on its strengths for the future. New communication channels are opened and cross functional data becomes available. Executive management becomes aware of emerging external risks sooner than their competitors. When implemented as a business driven effort, executives are focused on the interrelated risks that threaten the success of their strategic initiatives.

ERM opens communication throughout the institution regarding strategy and risk management. With an awareness of the institution's risks and opportunities, managers can better assist executives in understanding emerging threats and potential opportunities. Aligning ERM with strategic planning creates deliberate action to improve strategic execution. Financial institutions are now in a position to create confidence in their response to risk both for their board and regulators. ■



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Changing Goodwill Impairment Rules

As you complete your year-end financial statements, if you have goodwill carried on your balance sheet, you will need to perform the annual impairment test for this asset. The Financial Accounting Standards Board (FASB) has changed the rules for this test for all fiscal years beginning after Dec. 15, 2011. While no requirement to change is necessary for fiscal years ending Dec. 31, 2011, early adoption is permitted and encouraged by the FASB.

In April 2011, the FASB issued an exposure draft intended to simplify how businesses are required to test goodwill for impairment. The FASB gathered comments and issued Accounting Standards Update 2011-08 in September 2011 titled “Testing Goodwill for Impairment.”

ASC 350—Formerly a Two-Step Process

Goodwill impairment testing rules, formerly known as Statements on Financial Accounting Positions (SFAS) 142, are now found under Accounting Codification Standards (ASC) Topic 350—Intangibles—Goodwill and Other. The standard has been in place since 2001 and was essentially a two-step process.

The first step is to determine the fair value of the bank (or the reporting unit). If the fair value of the bank is greater than the equity book value (including goodwill) as of the measurement date, no further testing is necessary as no impairment exists. If the fair value of the bank is not greater than the book value, the second step must be completed.

The second step is to allocate the fair value of the bank to all of the assets (excluding goodwill) and liabilities of the bank as if it were acquired by a market participant on the measurement date. The excess fair value is then allocated to goodwill and compared to the book value of goodwill. The amount of write-off (or impairment) is equal to the book value of goodwill over the fair value of goodwill. The loss recognized cannot exceed the book value of goodwill on the measurement date.

Amendments to ASC 350

Topic 350 has been amended to allow businesses the option to first perform a qualitative assessment. Based on the results of the qualitative assessment,

an entity would not be required to perform the traditional two-step process unless it determines it is more likely than not (or greater than 50% probability) that the fair value is less than its carrying value.

Factors that should be considered in this qualitative assessment include, but are not limited to, the following:

- Economic conditions (macro and micro);
- Industry and market conditions (i.e., competitive environment, market multiples, regulatory changes);
- Negative changes in costs or financial performance indicators (i.e. negative cash flows or significant declines in revenues); and
- Entity specific events significantly affecting the management or financial condition of the reporting unit.

A more detailed listing of the qualitative factors can be found at www.fasb.org. This qualitative assessment should be documented in a memo and approved by the board of directors for the auditors and regulators. It is also important to understand that if the qualitative assessment is used, an entity is no longer able to carry forward its estimate of fair value from a prior period as previously permitted.

Despite this change, the amendment also allows an entity to opt out of the qualitative assessment in any period and perform the more traditional two-step test. An entity may elect to perform the qualitative assessment in any future period.

Whichever route one chooses to use in performing the annual impairment testing for goodwill, it remains important to support the assessments or calculations performed with proper documentation. This documentation will allow an entity to efficiently and effectively answer any questions examiners and auditors ask about your goodwill. ■



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Highlights from the 2011 Bankers Seminars

Thank you!

Thank you for attending the 2011 Bankers Seminar!

If you are interested in receiving any of the presentation materials from this year's seminar, please contact Cheryl Knudson at cknudson@eidebailly.com or 888.777.2015.

We enjoy providing this complimentary seminar to regional bankers—and look forward to seeing you in 2012.

2012 Bankers Seminar

Thursday, Oct. 25
Fargo

Thursday, Nov. 1
Mankato

Thursday, Nov. 8
Sioux Falls

Last Fall, Eide Bailly presented its 31st annual Bankers Seminar, "Banking on the Future," in Fargo, Sioux Falls and Mankato. This year's topics focused on challenges and opportunities for financial institutions in the coming year.

Approximately 700 bankers and advisors from the tri-state area heard presentations from national and regional experts in the industry, covering up-to-the-minute developments affecting financial institutions and local communities. Some of the keynote and after dinner presenter highlights include:

- In Fargo and Mankato, the keynote speaker, J. Michael Woody discussed today's community banking world, and the opportunities that exist if bankers break out of the "bunker mentality" from which we and the rest of the nation suffer. J. Michael Woody, owner and principal of J. Michael Woody, Inc., shared his vision of the incredible opportunities present in this challenging economic and regulatory environment, and offer strategies for growth in all areas.
- In Sioux Falls, the keynote speaker, Michael Boehlje, a distinguished professor in the Department of Agricultural Economics and the Center for Food and Agricultural Business (CAB) at Purdue University, and an agribusiness owner and manager, gave a presentation on the importance of strategic planning, thinking and positioning for long-term viability and success. Dr. Boehlje is the author or co-author of four books, and more than 450 articles and other publications
- In Fargo, the seminar concluded with dinner and a presentation from Dan Gabel, University of Iowa's all-time winningest wrestling coach from 1977-97, three-time Olympic head coach, and gold medalist at the 1972 Summer Olympics.
- In Mankato and Sioux Falls, the after dinner speaker was retired New York Fire Department Chief Richard Picciotto who recounted his survival of the terrorist attack on the World Trade Center on Sept. 11, 2001. Picciotto's

book, *Last Man Down*, is a tribute to the 343 firefighters and some 3,000 civilians who lay dead in the rubble that surrounded him. Moreover, it is a heartfelt remembrance of a day of infamy and profound humanity.

- At each of the seminars, a panel of banking regulators discussed regulatory challenges. Bankers were able to communicate directly with the regulators and uncover their perspective on current issues in the industry.

Highlights From the Presenters:

FARGO HIGHLIGHTS

A New Day in Compliance

Presenter: Ann Rockswold, Financial Institutions Compliance Senior Manager



Highlights: Participants learned about the changes that are coming from the formation of the Consumer Financial Protection Bureau (CFPB), the CFPB's role going forward, the summary of the challenges that banks have encountered in the last 12-18 months and what makes a strong compliance program. Because there is so much change in regulatory compliance, bankers need to be aware of increased risk and challenges.

Strategy Issues for Owners

Presenters: Tim LeClair, Fargo partner, and Dana Ereth, Bismarck Principal



Highlights: Attendees learned about the development and complexities of capital planning for banks and holding companies, and also reviewed trends in bank pricing in the Midwest. The presenters discussed how regulators require bank organizations to take a strategy approach to capital planning and that capital plans need to be more than "raise capital as needed." They must consider the organizational goals and should include

forecasted financial information to reflect the ability to meet internal capital targets.

In addition, capital plans should be stress tested for “what if” scenarios pertinent to the bank. The Office of Thrift Supervision (now part of the Office of the Comptroller of the Currency) and the Federal Reserve issued capital planning guidance. Bank organizations should review their capital plans and policies and consider strengthening their plans to ensure they are in a position to take advantage of opportunities that may be available in the future.

Participants also learned that there are opportunities available to buyers given the current trend of bank pricing. However, sellers that take a measured approach to the sale of their bank organizations will be rewarded for their efforts to improve asset quality and bank earnings.

Understanding Client Financial Statements and Cash Flows



Presenter: Wade Sandy, Fargo partner

Highlights: Participants learned about various accounting and reporting treatments for related-party transactions and related-party business entities. Attendees learned about the depth of work we do related to those transactions and

entities and what types of situations require consolidation of financial statements for related-party entities. The presentation also discussed the level of assurance individuals should place on client-prepared financial statements, and if having the client sign the financial statements could provide the banker with any additional assurance on the financial statements.

SIOUX FALLS HIGHLIGHTS

That Doesn't Happen Here: Bank Fraud Issues



Presenter: Danny Reynolds, Forensic Accounting Manager

Highlights: Attendees learned that fraud risk assessments for financial institutions is a complicated issue and depends on various factors regarding the institution such as size, markets and products being offered.

MANKATO HIGHLIGHTS

Regulatory Compliance Update



Presenter: Linda Albrecht, financial institutions compliance senior manager

Highlights: From dealing with post 9/11 to the passage of the Dodd-Frank Financial reform bill, professionals in the financial institution industry have had a decade of challenges.

Participants learned that since 9/11, financial institutions have had to implement policies and procedures to verify customer's identity, monitor for suspicious activity among customers, assess risks, search customer databases and be a watchdog for financial crime. Other industries, such as casinos, broker/dealers, currency exchangers, mutual funds and insurance companies have also been added to the list of industries required to implement Bank Secrecy Act and Anti-Money Laundering programs. This added attention has increased enforcement actions and the number of Suspicious Activity Reports (SAR's) filed since 2001 has increased 674%.

Attendees also learned the passage of the Dodd-Frank Financial reform bill in July 2010 presents a whole new set of challenges, most of them yet to come. Practices, once accepted as industry standard, are now being called unfair, abusive and deceptive. Participants questioned if this product or practice was ok. Even with all the unknown, one thing is for sure—now is not the time to reduce your compliance resources.

Succession Planning – Estate Planning for Bank Owners



Presenters: David Zaudtke, Minneapolis partner, and Mark Greiner, Fredrickson and Byron

Highlights: The presenters provided an interactive discussion regarding the legislative uncertainty with respect to estate and gift tax rules. Participants learned about several current strategies that can be used by Bank Owners to transfer wealth in a tax efficient and economically effective manner while accomplishing the owner's personal, business and charitable objectives. ■



For more information, visit: <http://www.eidebailly.com/financialinstitutions>.

Kevin Murphy—from page 1

the two largest banks, the average size drops down to \$62 million – so the failed banks were relatively small. Most were Twin Cities metro area banks, had a presence in the Twin Cities or had bought large numbers of participation loans in the metro area. Fortunately, we and the FDIC were able to resolve all of them by merger – there were no losses to any depositors, even uninsured ones and very little public inconvenience. One of the things Assistant Commissioner Bill Horlitz and I decided, in dealing with failed banks, was that we would take the high road. By that, I mean no surprise closures on Friday afternoons. In every case we sat down with the Board of Directors a week or two in advance and discussed with them exactly how the closing would work. In every case, we had full cooperation. Bank failures are always unpleasant, but we resolved them all with minimal hard feelings and minimal inconvenience to the public.

POSSIBILITIES: What changes do you see coming to the banking industry?

Murphy: There are some long term trends that will continue. One of the big ones is consolidation and that's for a variety of reasons. This has been underway for at least the last 30 years. Banks continue to merge, and while we may see more bank offices, we will have a lower number of banking charters. Another thing I expect is that profits for community banks will generally be lower than they have been in the past. One challenge for banks is finding good quality loans. With deleveraging going on at all levels of the economy, I see that as a continuing challenge.

POSSIBILITIES: What are the most common regulatory issues?

Murphy: We see a lot of issues related to accounting for the allowance for loan and lease losses – accounting is much more complicated now, especially related to foreclosures, troubled loans, and participation loans. With respect to troubled community banks, most are under a regulatory enforcement action of some sort. Most are able to comply; however, one of the

things that proves to be extremely difficult for troubled community banks is raising additional capital. This is not just a regulatory concern, but a major concern for bank owners and managers.

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

Murphy: In recent years there have been many new laws and rules applicable to the banking industry. Many of them are one-size-fits-all and it's very hard for community banks to keep up. It's also expensive. Banks are having to hire additional compliance people – some smaller banks are now discussing getting together to hire and share compliance staff. It's just another item that will eat into community banks' earnings. Unfortunately, I don't see the regulatory burden declining in the near future.

POSSIBILITIES: As you prepare to retire, what advice do you have for community bankers today?

Murphy: For community bankers today, it's very important that they have a very clear focus and that they pay close attention to and understand the financial needs of their customers. If possible, they should try to establish a niche, and identify things they can do better than the big banks. In the Twin Cities metro area, they compete for retail business with the big banks and will need to find ways to distinguish themselves from a variety of competitors. They also need to take considerable pains to avoid big loan or investment losses. One area where I do see opportunity for community banks is in the residential mortgage loan arena, particularly with non-conforming loans. A certain size or scale is necessary for a bank to be able to function in that niche and keep up with compliance issues, but a mortgage loan is still a very important relationship between a bank and a consumer. Banks need to capitalize on and expand these relationships. ■

A special thank you to Kevin Murphy for taking time to talk with Possibilities. Following this interview, Kevin retired from the Department of Commerce in December 2011. We wish him all the best in the years to come.

UDAAP – It's Here to Stay

Background

The term UDAAP (Unfair, Deceptive and Abusive Acts or Practices) is becoming a common term in daily conversation among the financial institution industry. What it means to the industry seems to be a mystery that depends on the interpretation of the day. Undoubtedly, UDAAP will impact all consumer products or services in some way.

The Dodd-Frank Act introduced UDAAP and directs the Consumer Financial Protection Bureau (CFPB) to issue regulations designed to prevent UDAAP. The additional "A" adds the term "abusive" to the mix. The CFPB's role is to supervise financial institutions' consumer products and services. Even though the old UDAP standards applied to commercial and consumer commerce, UDAAP will concentrate on products and services directed towards consumers.

UDAP and UDAAP are broad terms and difficult to define. Throughout the years, standards for what is unfair or deceptive have been interpreted by the courts. Going forward, UDAAP will be defined through the CFPB's rulemaking authority and will be enforced by them and existing bank regulators. Even though the CFPB lacks a defined organizational structure, the financial industry is already experiencing enforcement of "UDAAP" by existing bank regulators. This enforcement, particularly what surrounds overdraft practices, is creating a great deal of frustration among the community bank environment.

Definition

It is clear that following disclosure requirements dictated by various consumer regulations does not create the safe harbor we once thought. Just because a bank has diligently disclosed the terms and conditions of a product and has followed through accordingly with the delivery of that product does not insulate them from being scrutinized and deemed to be unfair, deceptive, or abusive in some way. The definition of UDAAP is evolving and continues

to be based, in large part, on interpretation. To help understand these speculative terms, the FTC and the Dodd-Frank Act have defined the terms unfair, deceptive and abusive.

What is "Unfair"?

- The practice causes or is likely to cause substantial injury that cannot be avoided and is not outweighed by any benefits.

What is "Deceptive"?

- The practice would likely mislead a "reasonable" consumer

What is "Abusive"?

- The practice materially interferes with the consumers ability to understand a term or condition of a product or service.

Targeted Products

Any consumer product or service has the potential of being criticized for possible UDAAP violations, but ones currently receiving a lot of attention are:

- Overdraft programs
- Check/debit processing order
- Loan payment processing
- ATM fees
- Loans with balloon payments
- Credit life and disability insurance sales
- Rewards programs
- Gift card sales
- Credit Card programs

The topic of overdrafts has consumed media headlines and has been the focus of regulatory exams since the implementation of rules surrounding the payment of overdrafts created by ATM and one-time debit card transactions. Just when you thought you were following all of the rules, banks are being forced to reimburse overdraft fees determined to be "unfair." If the overdraft program provides no benefit to the person who opted in to the payment of overdrafts created in this way compared to the person who opted-out, banks are being required to change their program AND reimburse affected customers. Changing your practice is not enough.

UDAP and UDAAP are broad terms and difficult to define. Throughout the years, standards for what is unfair or deceptive have been interpreted by the courts. Going forward, UDAAP will be defined through the CFPB's rulemaking authority and will be enforced by them and existing bank regulators.





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Managing Your UDAAP Risk

There is no doubt UDAAP will continue to challenge the industry, so it is essential for financial institutions to evaluate their risks and do what they can to diminish the impact violations may have on their organization.

Conclusion

The challenges and unknowns surrounding this rapidly growing trend of increased consumer protection will no doubt take up a greater percentage of your resources in the years to come. But with careful review and proactive steps, you can reduce the risk of potential violations and the long-term affects they could have on your organization.

For the complete article, please go to <http://www.eidebailly.com/industries/financial-institutions> and view our Insights section. ■



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